S. Hrg. 98-527

1983–84 MISCELLANEOUS TAX BILLS—VII: S. 120, S. 1397, S. 1584, S. 1814, S. 1815, and S. 1826

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

S. 120, S. 1397, S. 1584, S. 1814, S. 1815,
and S. 1826

SEPTEMBER 26, 1983

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
29-105 O WASHINGTON : 1984

S361-13

COMMITTEE ON FINANCE

ROBERT J. DOLE, Kansas, *Chairman*

BOB PACKWOOD, Oregon
WILLIAM V. ROTH, Jr., Delaware
JOHN C. DANFORTH, Missouri
JOHN H. CHAFEE, Rhode Island
JOHN HEINZ, Pennsylvania
MALCOLM WALLOP, Wyoming
DAVID DURENBERGER, Minnesota
WILLIAM L. ARMSTRONG, Colorado
STEVEN D. SYMMS, Idaho
CHARLES E. GRASSLEY, Iowa

RUSSELL B. LONG, Louisiana
LLOYD BENTSEN, Texas
SPARK M. MATSUNAGA, Hawaii
DANIEL PATRICK MOYNIHAN, New York
MAX BAUCUS, Montana
DAVID L. BOREN, Oklahoma
BILL BRADLEY, New Jersey
GEORGE J. MITCHELL, Maine
DAVID PRYOR, Arkansas

RODERICK A. DEARMENT, *Chief Counsel and Staff Director*
MICHAEL STERN, *Minority Staff Director*

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

BOB PACKWOOD, Oregon, *Chairman*

JOHN C. DANFORTH, Missouri
JOHN H. CHAFEE, Rhode Island
MALCOLM WALLOP, Wyoming
WILLIAM L. ARMSTRONG, Colorado

SPARK M. MATSUNAGA, Hawaii
LLOYD BENTSEN, Texas
MAX BAUCUS, Montana
RUSSELL B. LONG, Louisiana

CONTENTS

ADMINISTRATION WITNESSES

Page

Pearlman, Hon. Ronald A., Deputy Assistant Secretary for Tax Policy, Department of the Treasury 62

PUBLIC WITNESSES

Ainslie, Michael L., president, National Trust for Historic Preservation 227

Allen, Ann, member, board of directors, National Citizens Committee on Food and Shelter 308

American Bus Association, Norman R. Sherlock, president and chief executive officer 131

American Institute of Architects, William M. Dikis 210

Armco, Inc., Robert J. Lambrix, corporate vice president and treasurer, accompanied by Ernest Christian, Jr 235

Associated General Contractors of America, Billy Carter, chairman, tax and fiscal affairs committee 254

Barrese, Paul A., director of taxes, ASARCO, Inc., president, Tax Executives Institute, Inc., accompanied by Thomas M. Nee 260

Carter, Billy, vice president of finance, Nello L. Teer Co., chairman, tax and fiscal affairs committee, Associated General Contractors of America 254

Cheremeta, Paul, national president, Paralyzed Veterans of America 159

Dikis, William M., partner, Bussard/Dikis Association Ltd., on behalf of the American Institute of Architects 210

Ewing, William, national director of marketing, Second Harvest 303

Freight Forwarders Institute, Robert J. Frulla, president 114

Gashel, James, director of governmental affairs, National Federation of the Blind 199

Greyhound Lines, Inc., William L. McCracken, senior executive vice president 101

Hamsher, Frank, Counsel for Development, city of St. Louis, Mo 221

IC Industries, Inc., John F. Palmer, vice president and tax counsel 277

Iglehart, Philip, principal, RREEF Funds, accompanied by Lawrence Silverman 148

Lambrix, Robert J., corporate vice president and treasurer, Armco, Inc., accompanied by Ernest Christian, Jr 235

McCracken, William L., senior executive vice president, Greyhound Lines, Inc., accompanied by William J. Hallinan 101

Murphy, Stephen P., senior vice president and secretary, Yellow Freight System, Inc., accompanied by Robert J. Frulla, president, Freight Forwarders Institute 114

National Citizens Committee On Food and Shelter, Ann Allen, member, board of directors 308

National Federation of the Blind, James Gashel, director of governmental affairs 199

National Foreign Trade Council, Tom E. Persky, director of tax policy 287

National Trust for Historic Preservation, Michael L. Ainslie, president 227

Palmer, John F., vice president and tax counsel, IC Industries, Inc 277

Paralyzed Veterans of America, Paul Cheremeta, national president 159

Persky, Tom E., director of tax policy, National Foreign Trade Council 287

RREEF Funds, Philip Iglehart, principal 148

Second Harvest, William Ewing, national director of marketing 303

Sherlock, Norman R., president and chief executive officer, American Bus Association 131

Page
Tax Executives Institute, Inc., Paul A. Barrese, president, accompanied by Thomas M. Nee 260

ADDITIONAL INFORMATION

Committee press release 1
Description of S. 120, S. 1397, S. 1584, S. 1814, S. 1815, and S. 1826, by the Joint Committee on Taxation 2
Text of bills S. 120, S. 1397, S. 1584, S. 1814, S. 1815, and S. 1826 34
Prepared statement of Hon. Ronald A. Pearlman 68
Prepared statement of William L. McCracken 103
Prepared statement of Stephen P. Murphy 116
Prepared statement of Norman R. Sherlock 133
Letter to Senator Packwood from the National Association of Independent Colleges and Universities 145
Prepared statement of Philip Iglehart 149
Prepared statement of Paul Cheremeta 161
Prepared statement of James Gashel 201
Prepared statement of William M. Dikis 212
Prepared statement of Frank Hamsher 223
Prepared statement of Michael L. Ainslie 229
Prepared statement of Robert J. Lambrix 237
Prepared statement of Billy R. Carter 256
Prepared statement of Paul M. Barrese 262
Prepared statement of John F. Palmer 279
Prepared statement of Tom E. Persky 289
Prepared statement of William Ewing 305
Prepared statement of Ann Allen 310

COMMUNICATIONS

Aluminum Company of America 316
AMF, Inc., Blue Bell, Inc., Eaton Corp. and the Rochester Tax Council 318
Bucknell University 336
Council On Foundations 337
Grocery Manufacturers of America, Inc 338
Goldman, Sachs & Co 341
Machinery & Allied Products Institute 345
National Association of Manufacturers 353
The Nature Conservancy 354
Richard King Mellon Foundation 355
Scott Paper Co 357
The Singer Co 363
The Synanon Church 373

1983-84 MISCELLANEOUS TAX BILLS—VII: S. 120, S. 1397, S. 1584, S. 1814, S. 1815, and S. 1826

MONDAY, SEPTEMBER 26, 1983

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood and Danforth.

[The press release announcing the hearing, a description of S. 120, S. 1397, S. 1584, S. 1814, S. 1815, and S. 1826 by the Joint Committee on Taxation and the text of these bills follow:]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING ON S. 120, S. 1397, S. 1584, S. 1814, S. 1815 AND S. 1826

Senator Bob Packwod, Chairman of the Subcommittee on Taxation and Debt Management, announced today that a hearing will be held on Monday, September 26, 1983, on six miscellaneous tax bills.

The hearing will begin at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

The following legislative proposals will be considered:

S. 120.—Introduced by Senator Dole with Senators Symms, Pryor, Grassley, and others. The bill would restore for 2 years the deduction for expenses incurred in eliminating architectural or transportation barriers to the handicapped.

S. 1397.—Introduced by Senators Danforth and Eagleton. The bill would provide an alternative test for qualifying for the credit for rehabilitation expenditures.

S. 1584.—Introduced By Senator Danforth with Senators Bentsen and Huddleston. The bill would provide for treating domestic losses in the manner foreign losses are treated with respect to offsetting other income. The bill also would provide a 15-year carryover period for unused foreign tax credits and allow foreign tax credits to be used in the order earned.

S. 1814.—Introduced by Senator Packwood. The bill would allow an amortization deduction for bus operating rights based on a 60-month amortization period.

S. 1815.—Introduced by Senator Packwood. The bill would exempt from taxation corporations that acquire and manage real property for certain other tax-exempt organizations.

S. 1826.—Introduced by Senator Danforth. The bill would expand the special rule for certain charitable contributions of inventory and other property to encourage contributions of food and transportation services to organizations that provide food to the needy.

DESCRIPTION OF TAX BILLS
(S. 120, S. 1397, S. 1584, S. 1814, S. 1815, and S. 1826)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON SEPTEMBER 26, 1983

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on September 26, 1983, before the Senate Finance Subcommittee on Taxation and Debt Management.

The six bills scheduled for the hearing are: (1) S. 120 (relating to extending the allowance of the special deduction for expenses for removing barriers to the handicapped); (2) S. 1397 (relating to alternative test for qualification for the rehabilitation investment credit); (3) S. 1584 (relating to amendments to the foreign tax credit); (4) S. 1814 (relating to deduction for loss in value of bus operating authorities); (5) S. 1815 (relating to income tax exemption for certain title-holding corporations); and (6) S. 1826 ("Hunger Relief Incentives Tax Act of 1983").

The first part of the pamphlet is a summary of the bills. This is followed in the second part by a more detailed description of the bills, including present law, explanation of provisions, and effective dates.

I. SUMMARY

1. S. 120—Senators Dole, Symms, Pryor, Grassley, and others

Extend Allowance of Special Deduction for Expenses of Removing Barriers to the Handicapped

Under present law, the special deduction for qualified expenditures (up to $25,000 per year) incurred for the purpose of making facilities and certain vehicles accessible to, and usable by, handicapped and elderly individuals applies to expenses paid or incurred in taxable years beginning before 1983 (Code sec. 190). The bill would extend the existing deduction provision for two years, i.e., to qualified expenditures paid or incurred in taxable years beginning before 1985.

2. S. 1397—Senators Danforth and Eagleton

Alternative Test for Qualification for the Rehabilitation Investment Credit

Present law provides a three-tier investment credit for expenditures incurred in the rehabilitation of certain older buildings (Code sec. 48). The credit is equal to 15 percent of qualified rehabilitation expenditures in the case of buildings at least 30 years old; 20 percent in the case of buildings at least 40 years old; and 25 percent in the case of certified historic structures. Rehabilitations must satisfy certain requirements to be eligible for the credit, including a requirement that at least 75 percent of the external walls of the building must be retained as such after the rehabilitation.

The bill would provide an alternative to the 75-percent external-wall test where at least 50 percent of the external walls of the building are retained as such and certain other requirements are met. The provisions of the bill would apply retroactively to rehabilitation expenditures incurred after May 26, 1983.

3. S. 1584—Senators Danforth, Bentsen, and Huddleston

Amendments to the Foreign Tax Credit

a. Domestic loss recapture rule

Under present law, foreign losses of a U.S. taxpayer are, in effect, recaptured through the foreign tax credit limitation when the taxpayer subsequently derives foreign income (Code sec. 904(f)).

The bill would establish a domestic loss recapture rule the operation of which would be similar to the operation of the present foreign loss recapture rule. The bill would treat as foreign income a portion of domestic income derived after to a year in which a domestic loss is incurred. The effect of this recharacterization would be to increase the foreign tax credit limitation and, thus, potentially, the amount of utilizable foreign tax credits, in the later year or years.

This provision of the bill would apply retroactively to taxable years beginning after 1981.

b. Extended carryover for certain excess foreign tax credits

Under present law, excess foreign tax credits generally may be carried back for two years and carried over for five years (sec. 904(c)).

The bill would extend the foreign tax credit carryover period to 15 years for excess foreign tax credits that arise in taxable years beginning after 1978.

c. Ordering rule for foreign tax credits

Under present law, current foreign taxes are credited against U.S. tax before foreign taxes carried from other years are credited against U.S. tax (sec. 904(c)).

The bill would provide a new FIFO ordering rule for foreign tax credits. Under this rule, foreign tax credits would generally be utilized in the order in which they arose. Thus, in any taxable year, foreign tax credit carryovers would be utilized first, followed by credits for foreign taxes paid currently in the taxable year, then credit carrybacks.

The bill would also clarify the present computational rules for foreign tax credit carrybacks and carryovers.

The new ordering rule and related amendments would apply retroactively to taxable years beginning after 1981.

4. S. 1814—Senator Packwood

Deduction for Loss in Value of Bus Operating Authorities

Under present law, courts have denied an ordinary loss deduction (Code sec. 165) where the value of an operating permit or license decreased as a result of legislation expanding the number of issued licenses or permits. In 1981, as a result of the deregulation of the trucking industry, the Congress enacted a tax provision that allows trucking companies an ordinary deduction ratably over five years for loss in value of motor carrier operating authorities (sec. 266 of the Economic Recovery Tax Act of 1981). The value of bus operating authorities has diminished significantly as a result of Federal legislation that deregulated the intercity bus industry. The bill would provide tax deductions for the owners of bus operating authorities similar to that granted in 1981 with respect to motor carrier authorities.

The provisions of the bill would apply retroactively to taxable years ending after November 18, 1982.

5. S. 1815—Senator Packwood

Income Tax Exemption for Certain Title-Holding Corporations

Under present law, a corporation that is organized for the exclusive purpose of holding title to property, collecting income on the property, and distributing the net income to a tax-exempt organization is itself exempt from Federal income tax (Code sec. 501(c)(2)). The Internal Revenue Service interprets this provision to mean that the title-holding corporation may distribute income only to one or more "related" tax-exempt organizations.

The bill would exempt from Federal income tax any corporation organized exclusively to acquire, hold title to, and collect income from property and turn over all income (less expenses) from the property to one or more qualifying organizations, whether or not related. For this purpose, qualifying organizations would be (1) a qualified pension, etc., plan; (2) a governmental plan (sec. 414(d)); (3) the United States, any State or political subdivision, or any agency or instrumentality of such a governmental unit; or (4) any charitable organization (sec. 501(c)(3)).

The bill would be effective for taxable years beginning after 1983.

6. S. 1826—Senator Danforth

"Hunger Relief Incentives Tax Act of 1983"

Present law

Under present law, the amount of charitable deduction otherwise allowed for donated property generally must be reduced by the amount of any ordinary gain which the taxpayer would have realized had the property been sold at its fair market value on the date of the donation (Code sec. 170(e)). For example, a retailer which makes a charitable contribution of its inventory generally may deduct only its basis in the property.

However, under a special rule, corporations are allowed an augmented charitable deduction for qualified contributions to a public charity (other than a governmental unit) or a private operating foundation of certain types of ordinary income property donated for the care of the needy, the ill, or infants (sec. 170(e)(3)). The augmented charitable deduction allowed under this rule is generally for the sum of (1) the corporation's basis in the donated property and (2) one-half of the unrealized appreciation. In no event may the amount of the deduction exceed twice the basis of the property.

Under present law, no deduction is allowed for the value of services donated to a charitable organization. However, a taxpayer may deduct unreimbursed out-of-pocket expenses (such as fuel costs) incurred incident to the rendition of such services.

S. 1826

The bill would expand the section 170(e) augmented charitable deduction in a number of respects—

(1) *Eligible donees.*—The category of eligible donees for the augmented charitable deduction would be expanded to include governmental units.

(2) *Eligible donors.*—In the case of charitable contributions of food that otherwise qualify for the augmented charitable deduction, the bill would extend the category of eligible donors to include noncorporate taxpayers who are actively engaged in the trade or business of production or marketing of food.

(3) *Eligible contributions.*—Certain charitable contributions of transportation services for the movement of food would be treated as qualified contributions under the bill. In addition, contributions of food which a donee removes from the donor's fields ("gleaning") would be treated as qualified contributions.

The bill would provide special rules for computing the amount of the augmented charitable deduction for (1) qualified contributions of transportation services for the movement of food and (2) qualified contributions of food by a donor who is not required to and does not use inventories (e.g., farmers on cash-basis accounting for tax purposes).

The amendments made by the bill would be effective for qualified contributions made after the date of enactment.

II. DESCRIPTION OF THE BILLS

1. S. 120—Senators Dole, Symms, Pryor, Grassley, and others

Extend Allowance of Special Deduction for Expenses of Removing Barriers to the Handicapped

Present Law

Under present law, a taxpayer may elect each year to treat as a deductible expense up to $25,000 of expenditures incurred for purposes of making facilities and certain vehicles accessible to, and usable by, handicapped and elderly individuals (Code sec. 190). This provision applies to expenditures made in taxable years beginning before January 1, 1983.

The section 190 deduction was initially limited to taxable years beginning before 1980 in order to permit the Congress to review the cost effectiveness of the deduction. In 1979, the Congress made the provision applicable to taxable years beginning prior to 1983 (P.L. 96-167).

Explanation of the Bill

The allowance of the section 190 deduction for expenses of removing barriers to the handicapped and elderly (which applied for taxable years beginning before 1983) would be extended for two years, i.e., to such expenditures paid or incurred in taxable years beginning before January 1, 1985.

Effective Date

The bill would be effective on enactment. The changes that would be made by the bill would apply to taxable years beginning after 1982 and before 1985.

2. S. 1397—Senators Danforth and Eagleton

Alternative Test for Qualification for the Rehabilitation Investment Credit

Present Law

Present law provides a three-tier investment credit for expenditures incurred in the rehabilitation of certain older buildings (Code secs. 48(a)(1)(E) and 48(g)).

The rehabilitation credit is equal to 15 percent of qualified rehabilitation expenditures in the case of buildings at least 30 years old; 20 percent of such expenditures in the case of buildings at least 40 years old; and 25 percent of such expenditures in the case of certified historic structures. A certified historic structure is a building of a character subject to depreciation which is either listed in the National Register of Historic Places or located in an historic district approved by, and certified as contributing to the character of the district by, the Secretary of the Interior.

The 15- and 20-percent credits apply only to rehabilitations of commercial and industrial buildings; the 25-percent credit also applies to rehabilitations of depreciable residential property. For purposes of determining cost recovery deductions, the basis of a building with respect to which either the 15-percent credit or the 20-percent credit is allowed is adjusted for the full amount of the credit. The basis of a certified historic structure is adjusted by one-half of the allowable 25-percent credit.

Several conditions must be satisfied before a rehabilitation investment credit is allowable. The rehabilitation expenditures must exceed the greater of $5,000 or the adjusted basis of the building, and the building must have been placed in service before the beginning of rehabilitation. In addition, 75 percent or more of the existing external walls must remain in place as external walls after the rehabilitation.

Explanation of the Bill

The bill would provide an alternative test to the requirement that at least 75 percent of the external walls of a building must remain as such after completion of a qualified rehabilitation. Under the bill, the 75-percent requirement would be deemed to be satisfied if (1) 50 percent or more of the external walls are retained as such after completion of the rehabilitation; (2) 75 percent or more of the external walls are retained in place (even if not as external walls); and (3) 95 percent or more of the pre-rehabilitation internal structural framework is retained in place.

Effective Date

The provisions of the bill would apply retroactively to rehabilitation expenditures incurred after May 26, 1983.

3. S. 1584—Senators Danforth, Bentsen, and Huddleston

Amendments to the Foreign Tax Credit

Present Law

Foreign tax credit rules generally

The United States taxes the income of U.S. citizens, residents, or corporations whether that income is from U.S. sources or from foreign sources. The foreign tax credit was first enacted in 1918 to prevent U.S. taxpayers from being taxed twice on their foreign income—once by the foreign country where the income is earned and again by the United States. The foreign tax credit is intended to allow U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid to a foreign country. Foreign tax credits may not be used to offset U.S. tax on domestic income.

This foreign tax credit system embodies the principle that the country in which a business activity is conducted (or in which income is earned) has the first right to tax the income arising from activities in that country, even though the activities are conducted by corporations or individuals resident in other countries. Under this principle, the home country of the individual or corporation has a residual right to tax income arising from these activities, but recognizes the obligation to insure that double taxation does not result.

Some countries avoid double taxation by exempting foreign source income from tax altogether. However, most countries, including the United States, avoid double taxation through a foreign tax credit system, providing a dollar-for-dollar credit against home country tax liability for income taxes paid to a foreign country.

General limitation

A fundamental premise of the foreign tax credit is that it should not reduce the U.S. tax on U.S.-source income. Accordingly, the Code contains a limitation to insure that the credit offsets only the U.S. tax on the taxpayer's foreign income (Code sec. 904(a)). The limitation operates by prorating the taxpayer's total U.S. tax liability before tax credits ("pre-credit U.S. tax") between its U.S.- and foreign-source taxable income.[1] Therefore, the limitation is determined by using the ratio of foreign-source taxable income to total taxable income. The resulting fraction is multiplied by the total pre-credit U.S. tax to establish the amount of U.S. tax paid on the foreign income and, thus, the upper limit on the foreign tax credit.

The following example illustrates the computation of the foreign tax credit limitation. Assume that the U.S. taxpayer has foreign-source taxable income of $300 and U.S.-source taxable income of $200, for total taxable income of $500. Assume further that the pre-credit U.S. tax on the $500 is $230 (i.e., a 46-percent rate). Since 60 percent ($300/$500) of the taxpayer's total worldwide taxable income is from foreign sources, the foreign tax credit is limited to $138, or 60 percent of the $230 pre-credit U.S. tax. Thus, a taxpayer with foreign taxes paid in excess of $138 will be allowed a foreign tax credit of only $138 (the excess taxes paid may be carried to other years). If the taxpayer has paid less than $138 in foreign taxes, the taxpayer will have a foreign tax credit equal to the amount of the taxes paid.

---

[1] The pre-credit U.S. tax is the U.S. tax before all credits, that is, before the investment tax credit and other credits as well as the foreign tax credit.

Overall and per-country limitations

Historically, the foreign tax credit limitation has been determined based on either the taxpayer's total foreign income or the taxpayer's foreign income from each separate country, or both. These are known as the overall limitation and the per-country limitation, respectively.

Under the *overall method,* the taxpayer combines the income and losses from all foreign operations and allocates the pre-credit U.S. tax based upon this amount. Therefore, if (as in the example above) 60 percent of the taxpayer's taxable income is from all foreign sources combined, then the foreign tax credit is limited to 60 percent of the pre-credit U.S. tax.

Under the *per-country method,* the taxpayer determines the foreign tax credit on a country-by-country basis. Thus, the taxpayer is allowed to take a foreign tax credit for taxes paid to any particular foreign country only to the extent that the taxes paid to that country do not exceed the limitation separately determined for that country. In other words, under the per-country limitation, taxes paid to any foreign country can be used as credits only against the portion of the total pre-credit U.S. tax which is allocable to income from sources within that country.

In the Tax Reform Act of 1976, the Congress repealed the per-country limitation, making the overall limitation mandatory for most taxpayers.

Foreign loss recapture rule

Before the enactment of the Tax Reform Act of 1976, foreign losses of U.S. taxpayers generally had the effect of reducing the U.S. tax base.[2] U.S.-source income that would otherwise have been subject to U.S. tax went free of U.S. tax. In the case of a taxpayer who had foreign losses in excess of foreign income in a given year, the taxpayer could use the excess of the losses to reduce U.S. tax on U.S.-source income. Such losses reduced U.S. tax on U.S.-source income by decreasing the worldwide taxable income on which the U.S. tax was based.

Then, if the taxpayer later received income from abroad on which the taxpayer paid foreign tax, a foreign tax credit was allowed for the full amount of the foreign tax. Unless the taxpayer had an effective foreign tax rate no higher than the U.S. rate, and the foreign countries in which the losses originated had net operating loss carryover provisions (or some similar method of using prior losses to reduce subsequent taxable income), the taxpayer received an incidental U.S. tax benefit. This is because no U.S. tax was imposed on the subsequent year's income (to the extent of foreign taxes paid on the income), even though the earlier losses had reduced U.S. tax liability on U.S.-source income.

---

[2] The Tax Reduction Act of 1975 prevented reduction of the U.S. tax base by requiring recapture of foreign oil-related losses.

Example A (below) illustrates in more detail the erosion of the U.S. tax base and incidental benefit to the taxpayer that occurred when a taxpayer had foreign losses in excess of foreign income. Example A compares the U.S. tax computations for two taxpayers with the same total taxable worldwide income over a two-year period, one of whom has foreign losses in excess of foreign income in one year and one of whom does not. Example A illustrates the law prior to the enactment of the foreign loss recapture rule.

EXAMPLE A (PRE-1976 LAW)

	Year 1	Year 2	2-year total
Taxpayer 1 (overall foreign loss):			
Foreign-source income (loss)	($100)	$100	0
U.S.-source income	100	100	$200
Worldwide taxable income	0	200	200
Foreign tax (46 percent)	0	46	46
Pre-credit U.S. tax (46 percent)	0	92	92
Allowable foreign tax credit	0	[1] 46	46
Net U.S. tax	0	46	46
Excess foreign tax credit	0	0	0
Taxpayer 2 (no overall foreign loss):			
Foreign-source income (loss)	0	0	0
U.S.-source income	100	100	200
Worldwide taxable income	100	100	200
Foreign tax (46 percent)	0	0	0
Pre-credit U.S. tax (46 percent)	46	46	92
Allowable foreign tax credit	0	0	0
Net U.S. tax	46	46	92
Excess foreign tax credit	0	0	0

[1] Foreign tax credit limitation: Foreign source income ($100)/worldwide taxable income ($200) multiplied by U.S. tax ($92) equals $46.

In Example A, each taxpayer has a total 2-year U.S.-source taxable income of $200. The taxpayer with an overall foreign loss (Taxpayer 1) pays U.S. tax of $46 for the 2-year period (a 23-percent

U.S. tax rate on U.S. income)—one-half of the amount paid by Taxpayer 2, the taxpayer with no foreign loss, and one-half of the amount normally due on $200 of U.S.-source taxable income, assuming a 46-percent average U.S. tax rate.

The Congress responded to the overall foreign loss issue by including in the Tax Reform Act of 1976 a rule which requires that losses from foreign operations and, thus, the tax benefit derived from the deduction of these losses should be recaptured by the United States when the taxpayer subsequently derives income from abroad.[3]

In general, the recapture is accomplished under Code section 904(f) by treating a portion of foreign income which is subsequently derived as income from domestic sources. The portion of foreign income treated as income from domestic sources represents the overall foreign loss which in the previous taxable year may have reduced U.S. tax on income from domestic sources. The effect of the recharacterization is to reduce the foreign tax credit limitation in one or more subsequent years and, therefore, the amount of U.S. tax that can be offset by foreign tax credits in such subsequent year or years.[4]

The amount of foreign income which is treated as income from domestic sources in a subsequent year is limited to the lesser of the amount of the overall loss (to the extent that the loss has not been recaptured in prior taxable years) or 50 percent of the foreign taxable income for that year, or such larger percent as the taxpayer may choose.

For the purposes of the foreign loss recapture rule, the term overall foreign loss means the amount by which the taxpayer's (or in the case of an affiliated group filing a consolidated return, the group's) gross income from sources without the United States is exceeded by the sum of the expenses, losses, and other deductions which could be allocated to foreign sources for purposes of computing the foreign tax credit limitation, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income (under Code sec. 862(b)). In computing the amount of the foreign loss, the net operating loss deduction (under sec. 172(a)) is not to be taken into account. In addition, foreign expropriation losses (as defined in sec. 172(k)(1)) or unreimbursed casualty or theft losses are not subject to the recapture provision. A taxpayer is treated as sustaining a foreign loss whether or not claiming a foreign tax credit for the year of the loss.

Section 904(f) also contains a provision which provides for the recapture of loss when property which was used in a trade or business, and which was used predominantly outside of the United States, is disposed of prior to the time the loss has been fully recaptured. This provision applies regardless of whether gain would otherwise be recognized.

---

[3] In 1969, the House of Representatives passed a foreign loss recapture provision that would have applied to taxpayers electing the now-repealed per-country limitation (H.R. 13270, 91st Cong., 1st Sess.; see H.R. Rep. No. 91-143, agreement between the House and the Senate did not include that provision. In the Tax Reduction Act of 1975, the Congress enacted a foreign loss recapture rule that applied only to foreign oil–related income (Public Law 94-12, sec. 601, adding Code sec. 907(f)).

[4] This recharacterization is also referred to as re-sourcing or simply as recapture.

Where gain would otherwise not be recognized, the taxpayer is treated under this provision as having received gain which is recognized in the year the taxpayer disposes of the property. (The gain to be recognized is limited to the amount of the foreign losses not yet recaptured.) In the case of a recapture resulting from the disposition of the property, 100 percent of the gain (to the extent of losses not previously recaptured) is recaptured. In such a case the 50-percent of gain limit is not applied, and the amount (if any) to be recaptured in future years is reduced by the full amount of the gain.

The application of the foreign loss recapture rule of current law is illustrated in Example B (below). The taxpayer in Example B is Taxpayer 1 of Example A. For simplicity, Example B assumes that Taxpayer 1 chooses to have 100 percent of the foreign income recharacterized as domestic income in the year in which recharacterization takes place.

EXAMPLE B (PRESENT LAW)

	Year 1	Year 2	2-year total
Taxpayer 1:			
Foreign-source income (loss)	($100)	$100	0
U.S.-source income	100	100	$200
Worldwide taxable income	0	200	200
Foreign tax (46 percent)	0	46	46
U.S. tax (46 percent)	0	92	92
Allowable foreign tax credit	0	[1] 0	0
Net U.S. tax	0	92	92
Excess foreign tax credit	0	46	46

[1] Foreign tax credit limitation: Foreign source income (zero, since it has been recharacterized as U.S. income)/worldwide taxable income ($200) multiplied by U.S. tax ($92) equals 0.

Under the foreign loss recapture rule, Taxpayer 1 pays $92 of U.S. tax on U.S.-source taxable income of $200 for the 2-year period. A comparison of Examples A and B shows that this is the same amount of U.S. tax paid by Taxpayer 2 in Example A, who also had U.S.-source taxable income of $200 for the two-year period, but no foreign losses.In addition, $92 of U.S. tax is the amount normally due on $200 of U.S.-source taxable income, assuming a 46-percent average U.S. tax rate.

Foreign tax credit carryovers

Under present law, excess foreign tax credits (*i.e.*, foreign taxes which, because of the foreign tax credit limitation, cannot be credited in the year paid or accrued) generally may be carried back for 2 years and carried forward for five years (sec. 904(c)).

The Congress enacted the foreign tax credit carryback and carryover in 1958 to eliminate the double taxation which sometimes resulted under prior law when a method of reporting income in a foreign country differed from the method in the United States. This may result in reporting the same income in one year in the United States and in another year in the foreign country. When this occurs, the foreign tax credit currently available under the foreign tax credit limitation tends to be less than the taxes paid or accrued to the foreign country in the year the income is reported in that country but not in the United States. In another year when this income is reported in the United States but not the foreign country, the credit which will be available currently under the limitation tends to exceed the foreign taxes paid or accrued.[5]

Section 904(c) permits foreign taxes which cannot be claimed currently as a tax credit to be carried back successively to the second and first preceding taxable years and then forward to the first, second, third, fourth, and fifth succeeding taxable years. The credits so carried are deemed paid or accrued in the earlier or later years and may be used in such years to the extent that creditable foreign taxes actually paid or accrued for such years do not equal or exceed the applicable foreign tax credit limitation amounts. Under this rule, current foreign taxes are credited against U.S. tax before foreign taxes carried from other years are credited against U.S. tax.

In contrast with foreign tax credits, investment tax credits generally may be carried forward for 3 years and carried over for 15 years (sec. 46(b)). In addition, investment tax credits are utilized in accordance with a first-in first-out (FIFO) ordering rule. Under this rule, investment credit carryovers are used before current investment credits (sec. 46(a)(1)).

In any taxable year, foreign tax credits (including carrybacks and carryovers) are used before all other types of income tax credits, excluding the credit for the elderly. However, net operating loss carrybacks and carryovers generally reduce income, and hence U.S. tax, before foreign tax and other credits are used.

---

[5] The report of the House Committee on Ways and Means on the legislation creating the foreign tax credit carryback and carryover listed factors which may result in a difference in the timing of reporting of income and allowance of deductions: "(1) Reporting of taxable income from sales on the installment basis in the United States without being permitted to report in a similar manner in a foreign country (or possession of the United States); (2) Differences under the laws of the United States and those of the foreign country in the pricing of inventories (this may result in the reporting of income from the ultimate sale of such articles in a different year in the United States than in the foreign country); (3) Differences in reporting foreign exchange profit or loss (such profit or loss may be reported on the accrual basis in the United States but only on the cash basis in some foreign countries); (4) Differences in depreciation methods in the United States and in the foreign country; (5) The requirement of some countries that income taxes be determined only on a fiscal-year basis; and (6) The use of an averaging device in the computation of taxable income in certain foreign countries covering more than one taxable year. *See* H.R. Rep. No. 775, 85th Cong., 1st Sess. 27-28 (1957).

Explanation of the Bill

a. Domestic loss recapture rule

In general

The bill would establish a domestic loss recapture rule the operation of which would be similar to the operation of the present foreign loss recapture rule (Code sec. 904(f)).

The recapture of domestic losses would be accomplished under the bill by treating as income from foreign sources a portion of domestic income which is derived after a year in which an overall domestic loss is incurred. The portion of domestic income treated as income from foreign sources would represent the overall domestic loss which, in the previous year, had the effect of reducing precredit U.S. tax and, consequently, the potentially utilizable amount of foreign tax credits in that year. The effect of the recharacterization would be to increase the foreign tax credit limitation and, thus, potentially, the amount of utilizable foreign tax credits, in the later year or years.

Amount subject to recapture

The amount of domestic income treated as foreign-source income in a subsequent year would be limited under the bill to the lesser of the amount of the overall domestic loss (to the extent that the loss has not been recaptured in prior taxable years) or 50 percent of the domestic taxable income for that year, or such larger percentage as the taxpayer may choose. Thus, in any taxable year the amount subject to recapture would not exceed 50 percent of the taxpayer's domestic income (before recharacterization), unless the taxpayer chose to have a greater percentage of domestic income so recharacterized.

Definition of overall domestic loss

For purposes of the domestic loss recapture rule, the bill would define the term overall domestic loss to mean the amount by which the taxpayer's gross income from sources within the United States (including the amount, if any, that is treated as income from sources within the United States under the foreign loss recapture rule) is exceeded by the sum of the deductions properly apportioned or allocated to domestic sources, to the extent such loss amount offsets income from foreign sources.

In computing the amount of the overall domestic loss, casualty or theft losses would not be taken into account. The definition of overall domestic loss contained in the bill, unlike the present-law definition of overall foreign loss (Code sec. 904(f)(2)), would not expressly provide that the net operating loss deduction (sec. 172(a)) is not to be taken into account in computing the overall loss. Under the bill, a taxpayer would be treated as sustaining a domestic loss whether or not claiming a foreign tax credit for the year of the loss.

Amendments to foreign loss recapture rule

The bill would amend the foreign loss recapture rule in a minor respect. It would modify the definition of overall foreign loss for foreign loss recapture rule purposes so that domestic income recharacterized as foreign income under the domestic loss recapture rule would be counted in the computation of overall foreign loss.

Example

Example C (below) shows how, under present law, two taxpayers with the same total taxable worldwide income and foreign taxes over a two-year period, one of whom has domestic losses in one year and one of whom does not, may pay different amounts of U.S. tax and may use different amounts of foreign tax credits over the two-year period.

EXAMPLE C (PRESENT LAW)

	Year 1	Year 2	2-year total
Taxpayer 3 (overall domestic loss):			
Foreign-source income (loss)	$100	$100	$200
U.S.-source income	(100)	100	0
Worldwide taxable income	0	200	200
Foreign tax (46 percent)	46	46	92
Pre-credit U.S. tax (46 percent)	0	92	92
Allowable foreign tax credit	0	[1] 46	46
Net U.S. tax	0	46	46
Excess foreign tax credit	46	0	46
Taxpayer 4 (no overall domestic loss):			
Foreign-source income (loss)	100	100	200
U.S.-source income	0	0	0
Worldwide taxable income	100	100	100
Foreign tax (46 percent)	46	46	92
Pre-credit U.S. tax (46 percent)	46	46	46
Allowable foreign tax credit	46	[2] 46	92
Net U.S. tax	0	0	0
Excess foreign tax credit	0	0	0

[1] Foreign tax credit limitation: Foreign source income ($100)/worldwide taxable income ($200) multiplied by U.S. tax ($92) equals $46.

[2] Foreign tax credit limitation: Foreign source income ($100)/worldwide taxable income ($100) multiplied by U.S. tax ($46) equals $46.

In Example C, each taxpayer has a total two-year worldwide taxable income of $200. Each has no U.S.-source taxable income for the two-year period. The taxpayer with an overall domestic loss (Taxpayer 3) pays $46 in U.S. tax and $92 in foreign tax for the two-year period and accrues $46 of excess foreign tax credits. Taxpayer 4, the taxpayer with no domestic loss, pays no U.S. tax and

$92 in foreign tax for the two-year period and accrues no excess foreign tax credits.

Enactment of the domestic loss recapture rule would have the effect on Taxpayer 3 illustrated in Example D below. Example D assumes that Taxpayer 3 chooses to have 100 percent of U.S.-source income recharacterized as foreign income in Year 2.

EXAMPLE D (UNDER S. 1584)

	Year 1	Year 2	2-year total
Taxpayer 3:			
Foreign-source income (loss)	$100	$100	$200
U.S.-source income	(100)	100	0
Worldwide taxable income	0	200	200
Foreign tax (46 percent)	46	46	92
U.S. tax (46 percent)	0	92	92
Allowable foreign tax credit	0	[1] 92	92
Net U.S. tax	0	0	02
Excess foreign tax credit	46	(46)	0

[1] Foreign tax credit limitation: Foreign source income ($200, since the domestic income in Year 2 is recharacterized as foreign income)/worldwide taxable income ($200) multiplied by $92 equals $92.

Under the domestic loss recapture rule, Taxpayer 3 would pay no U.S. tax and accrue no excess foreign tax credits for the two-year period. A comparison of Examples C and D shows that this is the same U.S. tax and excess foreign tax credit position as that of a taxpayer who does not have domestic losses (Taxpayer 4).

Effective date

The domestic loss recapture rule and related amendments would apply to taxable years beginning after 1981.

b. Extended carryover period for certain excess foreign tax credits

The bill would increase the foreign tax credit carryover period from five years to 15 years for excess foreign tax credits that arise in taxable years beginning after 1978.

c. FIFO ordering rule for foreign tax credits

In general

The bill would provide a new first-in first-out (FIFO) ordering rule for utilization of foreign tax credits. Under this rule, foreign tax credits that arise currently in the taxable year would no longer be the first foreign tax credits utilized in the taxable year; instead, foreign tax credits would generally be utilized in the order in which they arose. Thus, in any taxable year, foreign tax credit carryovers would be utilized first.

If such carryovers did not equal or exceed the foreign tax credit limitation for the year, then foreign tax credits arising currently would be utilized. If the sum of the foreign tax credit carryovers and current credits did not equal or exceed the foreign tax credit limitation for the year, then foreign tax credit carrybacks would be utilized.

The bill would also clarify the present computational rules for foreign tax credit carrybacks and carryovers.

Effective date

The FIFO ordering rule and related amendments would be effective with respect to taxable years beginning after 1981.

ISSUES

Excess foreign tax credits

Excess foreign tax credits result when the amount of foreign creditable income taxes paid or accrued in a given year exceeds the taxpayer's foreign tax credit limitation. Excess credits are, therefore, the result of the limitation and can arise for a variety of reasons, all of which involve the limitation. Timing differences in the reporting of income and deductions under U.S. and foreign tax laws may result in a taxpayer's being unable to utilize some foreign tax credits in a year in which income is reported in a foreign country but not in the United States. Differences between the sourcing rules or the deduction allocation rules of the United States (whose rules are consistent with international norms generally recognized by developed countries) and those of other countries may result in U.S. treatment of income taxed by another country as domestic income for purposes of the foreign tax credit.[6] Also, effective corporate income tax rates in many countries are higher than U.S. income tax rates.

Today, a significant reason for excess credits of some companies is domestic losses. Domestic losses may reduce worldwide taxable income and pre-credit U.S. tax and, hence, the amount of foreign tax credits that can be used currently.

Proponents of S. 1584 argue that excess credits represent an additional cost of conducting business abroad that can place U.S. companies at a competitive disadvantage vis a vis foreign companies. The bill, they argue, by reducing excess credits, would prvent double taxation, reduce this additional cost, and improve the competitive position of U.S. companies.

Tax planning

The focus of international tax planning by U.S. taxpayers is the maximization of foreign tax credit utilization. By increasing foreign tax credit utilization, a taxpayer can reduce its worldwide tax burden. Under present law, taxpayers have a number of planning opportunities. For example, taxpayers can increase credit utilization through their control of the timing of dividend payments by foreign subsidiaries and the timing of deemed distributions under the controlled foreign corporation rules (Code secs. 951–64, often referred to as Subpart F).

---

[6] For example, many developing countries impose gross withholding taxes on payments for technical services that a U.S. taxpayer performs in the United States for use within their borders. The United States treats the payments as U.S. domestic source income for purposes of computing the foreign tax credit limitation, with the result that the foreign taxes may not be creditable in the year paid.

Those favoring the bill argue that by reducing excess foreign tax credits, the bill would reduce current planning pressures. Others argue, however, that the bill might provide expanded planning opportunities that would allow some taxpayers to reduce U.S. tax in unintended ways.

Annual accounting period

Some taxpayers with equal worldwide incomes and effective foreign tax rates over a period of years pay different total amounts of U.S. tax because of differences in the distribution of income and loss over the period. It is the required use of the annual accounting period that causes these differences in income distribution over time to produce differences in U.S. tax liabilities among similarly situated taxpayers.

Proponents of the bill point out that the Code contains numerous provisions to mitigate these differences in tax liabilities, such as the foreign tax credit carryover and carryback. The use of the annual accounting period, they note, is arbitrary; it is used primarily for administrative convenience. They argue further that taxpayers who are able to control the timing of income and loss can avoid the harsh effects of the annual accounting period and, therefore, such taxpayers enjoy an unfair advantage over taxpayers who are unable to control the timing of income and loss.

Proponents of S. 1584 argue that the bill would reduce differences (attributable to the use of the annual accounting period) in the U.S. tax liabilities of taxpayers with the same worldwide incomes and effective foreign tax rates over a period of years. For example, as Examples C and D (above) indicate, the domestic loss recapture rule would equalize the U.S. tax burdens of two taxpayers with equal worldwide incomes and foreign taxes over a two-year period, one of whom has a domestic loss during the period, and one of whom does not. Similarly, the extension of the carryover period for foreign tax credits would prevent the expiration of foreign tax credits and would, therefore, reduce U.S. tax differences between taxpayers with the same total foreign taxes over a period of years, some of whom can credit their foreign taxes currently, and some of whom cannot.

Reduction of foreign income by domestic losses

As indicated above, under the present U.S. system of computing worldwide taxable income, domestic losses initially offset same-year foreign income. Only those losses in excess of same-year foreign income may be carried back or forward. Because domestic losses reduce worldwide income and hence pre-credit U.S. tax, the losses may cause foreign tax credits (and other income tax credits) to expire unused. Proponents of the legislation argue that the bill would significantly ease the credit expiration problem.

In addition, those favoring the bill argue that taxpayers who have domestic losses and pay foreign taxes in the same taxable year may lose the full benefit of accelerated cost recovery system

(ACRS) deductions and other investment incentives. ACRS deductions contribute to domestic tax losses, which offset same-year foreign income. A taxpayer with high-taxed foreign income pays no U.S. tax on that income, because of the foreign tax credit. If this taxpayer also has a U.S. tax loss including ACRS deductions, those ACRS deductions do not reduce current U.S. tax, and they are not available for carryover. Proponents of the bill argue that if ACRS deductions are lost, taxpayers are not receiving the tax benefit that Congress intended in enacting ACRS. Domestic loss recapture, they argue, would in effect return the benefits of ACRS to the taxpayers in later years.

Some have suggested that the real problem is that U.S. losses offset foreign income, and foreign losses offset U.S. income. They have suggested an alternative system for computing worldwide taxable income, sometimes called a "separate basket" system, be substituted for the present system. Under a separate basket system, the aggregation of same-year domestic and foreign income (and loss) would be eliminated, and domestic losses would be carried back or forward in their entirety. Domestic losses in a taxable year would no longer displace foreign tax credits that would otherwise have been utilized in that year. The carryback and carryover of domestic losses in their entirety would preserve ACRS deductions. A separate basket system would eliminate the need for the foreign loss recapture rule as well as the need for the domestic loss recapture rule.

Domestic loss recapture rule

Consistency in tax treatment of foreign and domestic losses.—Proponents of the domestic loss recapture rule argue, on the other hand, that the Congress overlooked the domestic loss issue when it considered and enacted the foreign loss recapture rule in 1976. The substantial domestic losses incurred by some companies in recent years, proponents suggest, have pushed the issue into prominence and increased the need for domestic loss recapture. The amendments required to implement the domestic loss recapture rule, they argue further, are technical rather than substantive in nature.[7]

In the view of proponents, consistency in the tax treatment of foreign and domestic losses requires the adoption of the rule. They argue that, just as the foreign loss recapture rule eliminated disparities in the tax treatment of taxpayers who differed only in that some had overall foreign losses over a period of years and some did not, the domestic loss recapture rule would eliminate disparities in the tax treatment of taxpayers who differ only in that some have overall domestic losses over a period of years and some do not. In their view, the domestic loss recapture rule is needed to establish symmetry in the rules governing losses.

On the other hand, it can be argued that the foreign loss recapture rule arose in response to certain specific problems in the operation of the foreign tax credit system with which domestic losses are unconnected. The foreign loss recapture rule was enacted because overall foreign losses reduced U.S. tax while U.S. tax on foreign income in later years was reduced or eliminated by foreign income taxes imposed on that income. Often, the losses were start-up losses from new foreign investment by the U.S. taxpayer, and the foreign income tax in the second year resulted because the foreign country did not allow a carryover of the prior years' losses. The result was that the U.S. Treasury bore the cost of the foreign investment while the foreign country got the tax on the income from the investment. Thus, it could be argued that the foreign loss recapture rule protects the revenue by preventing taxpayers from gaining a double benefit at the expense of the Treasury.

---

[7] Proponents of the domestic loss recapture rule also assert that the failure to enact the rule in 1976, when the Congress enacted the foreign loss recapture rule, amounted to a partial repeal of the foreign tax credit.

In any event, it can be argued, the domestic loss recapture rule, as presently drafted in S. 1584, would not establish consistency in the tax treaty of foreign and domestic losses. Losses of foreign susidiaries are not recaptured under the foreign loss recapture rule; only losses of foreign branches or losses on the sale of stock or other assets are.[8] Under S. 1584, by contrast, domestic losses are recaptured to the extent they offset either foreign branch or foreign susidiary income. Also, as discussed in more detail below, S. 1584 does not have a provision like the foreign loss recapture rule provision requiring recapture upon the disposition of certain property.

Incentive to reduce foreign taxes.—Because the United States provides a foreign tax credit, incentives to reduce foreign taxes may increase U.S. tax revenues. As noted previously, the overall limitation prevents a taxpayer in any taxable year from crediting foreign taxes in excess of total pre-credit U.S. tax on foreign-source income for the taxable year. The overall limitation thus gives taxpayers an incentive to keep their total foreign taxes at a level no higher than their total pre-credit U.S. taxes on foreign income.[9] The domestic loss recapture rule might reduce this foreign tax reduction incentive somewhat; the re-resourcing of certain domestic income as foreign income for purposes of the foreign tax credit limitation would permit some taxpayers in some years to credit foreign taxes in excess of pre-credit U.S. tax on foreign income.

However, as proponents of the bill have pointed out, use by the United States of a foreign tax credit (rather than a foreign income exemption) system already removes much of a taxpayer's incentive to reduce foreign taxes and, consequently, the impact of the domestic loss recapture rule on the incentive would be relatively slight.

Transfer of domestic loss recapture benefits.—The existence of recoverable losses of a company might be regarded as a financial asset by would-be acquiring corporations. Various provisions of present law restrict the transfer of other tax attributes, such as net operating losses and excess foreign tax credits, between acquired and acquiring corporations. The bill does not contain any restriction on the use by an acquiring corporation of an acquired company's domestic loss recapture benefits. Such a restriction may be necessary to prevent trafficking in domestic loss recapture benefits.

---

[8] Losses of foreign subsidiaries are not recaptured because such losses are not included in the computation of worldwide income for U.S. tax purposes.

[9] This incentive operates over time rather than discretely in each year because of the foreign tax credit carryover and carryback.

Proponents of the bill argue that, while a company with a recapturable domestic loss might be more attractive to a would-be acquiring corporation than a company with a domestic loss not subject to recapture, as between a company without losses and a company with a recapturable domestic loss, the comparative attraction of the loss company would not be greatly enhanced by the domestic loss recapture rule.

If a restriction on the use by an acquiring corporation of an acquired company's domestic loss recapture benefits is deemed necessary, some proponents suggest that it might be modelled after the limitation on transfer of the consolidated foreign tax credit carryover and carryback contained in the Treasury regulations governing consolidated returns (Treas. Reg. sec. 1.1502).

Recapture of loss upon disposition of property.—The foreign loss recapture rule contains a provision that requires the recapture of loss when property which was used in a trade or business, and which was used predominantly outside the United States is disposed of prior to the time a loss has been fully recaptured (Code sec. 904(f)(3)). This provision applies regardless of whether gain on the disposition of the property would otherwise be recognized. The bill does not contain a parallel provision for domestic loss recapture applicable to dispositions of property used predominantly within the United States.

Proponents of the bill argue that such a parallel provision would be inappropriate. Section 904(f)(3) is necessary, in their view, to prevent taxpayers from avoiding foreign loss recapture by avoiding recognition of foreign gains. There is, on the other hand, they argue, no apparent policy reason for requiring the recognition of gain otherwise accorded nonrecognition treatment on the disposition of domestic-use property. Nor is there any apparent policy reason, they suggest, for the creation of foreign-source income which the taxpayer would not otherwise have upon the disposition of domestic-use property.

Tax benefit rule.—There is no requirement in the bill that creditable foreign taxes be paid on foreign income offset by domestic losses for recapture of such losses to occur. In the absence of such a requirement, the domestic loss recapture rule may be inconsistent with tax benefit principles. The reason is that, without such a requirement, domestic loss recapture could (as previously noted) take place with respect to domestic losses that do not generate excess foreign tax credits. Since an important purpose of domestic loss recapture is to facilitate the use of excess credits resulting from domestic losses, no recapture arguably should be allowed with respect to losses that generate no excess credits.

Proponents of the bill argue that even if no creditable foreign taxes are paid in a domestic loss year, the domestic loss normally restricts foreign tax credit utilization since taxpayers often have excess credits from other years that could be carried to the domestic loss year, but for the domestic loss. Therefore, permitting recapture of domestic losses even in years when no foreign tax credit arises currently, they argue, does not conflict with tax benefit principles.

Extended carryover period for excess credits

Those who favor the extension of the foreign tax credit carryover period from five to 15 years argue that the extension would conform the foreign tax credit carryover period with the current 15-year carryover period for net operating losses and investment tax credits (and the 15-year carryover period for the targeted jobs credit, the alcohol fuels credit, and the research credit).

The proponents of the provision point out that the carryover and carryback periods for net operating losses and investment tax credits have been liberalized several times over the last few decades, while the carryback and carryover periods for the foreign tax credit have not been changed since the carryback and carryover were first enacted in 1958. They note the recognition by the Congress that net operating losses (by reducing pre-credit U.S. tax) may cause both investment tax credits and foreign tax credits to expire unused; they argue that the enactment of the accelerated cost recovery system (ACRS) in 1981 potentially increased the magnitude of the problem, since ACRS deductions may increase net operating losses. The Congress, they argue, tried to forestall this unintended result of ACRS in the case of the investment tax credit, by extending the investment tax credit carryover period to its present 15 years at the time ACRS was enacted.

Proponents further argue that the appropriate length for any carryover period (whether for net operating losses, investment tax credits, or foreign tax credits) cannot be determined with absolute precision. Therefore, in their view, a carryover period should be sufficiently lengthy to minimize the likelihood that the purpose of the tax attribute at issue (i.e., net operating losses, investment tax credits, or foreign tax credits) will be frustrated by the expiration of that tax attribute.

On the other hand, the present two-year carryback, five-year carryover, it can be argued, preserves the "matching" rule inherent in the foreign tax credit system: to prevent double taxation, a foreign tax credit is allowed for foreign taxes paid on certain income in order to offset pre-credit U.S. tax on *that* income. As discussed earlier, the Congress enacted the foreign tax credit carryback and carryover because differences in the rules for reporting income in the United States and other countries sometimes resulted in reporting the same income in one year in the United States and in another year in a foreign country. When income was reported in the United States in an earlier year than in a foreign country, the foreign taxes paid or accrued in the earlier year, and therefore the applicable foreign tax credit, tended to fall short of the foreign tax credit limitation. Thus, the foreign taxes did not fully offset U.S. tax on that income in the earlier year. Later, when the income was reported in the foreign country, the foreign taxes paid or accrued in the later year, and therefore the applicable foreign tax credit, tended to exceed the foreign tax credit limitation. These foreign taxes could not be used to offset the earlier-imposed U.S. tax on the income.

The present two-year carryback and five-year carryover arguably prevent the mismatching of income and credits and consequent double taxation that resulted from such timing differences in the reporting of income under U.S. law and foreign law.

A longer carryover (or carryback), on the other hand, might permit the foreign taxes paid on one year's income to offset pre-credit U.S. tax on another year's income (after timing differences in reporting income are accounted for), and thus contravert the matching principle. If the length of the present carryover period already, on occasion, gives rise to such mismatching, then extending the carryover period would, of course, enlarge the problem.

A longer carryover period may be appropriate for the investment tax credit and net operating loss because the purposes of the carryover for these tax attributes differ significantly from the purpose of the carryover for the foreign tax credit. That is, the matching principle just described has no apparent relevance to the investment tax credit or net operating loss.

The purpose of the investment tax credit carryover is to preserve the investment incentive that the investment tax credit was enacted to provide. The net operating loss carryover functions as a general averaging device to alleviate the harsh effects often resulting from the use of the one-year accounting period. The net operating loss carryover also shields businesses during difficult economic times and reduces differences in the total tax liabilities, over a multi-year period, of taxpayers with equal incomes over the period, some of whom have net operating losses and some of whom do not during the period.

FIFO ordering rule

Proponents of the adoption of a first-in first-out (FIFO) ordering rule for utilization of foreign tax credits argue that the adoption of a FIFO rule would conform the foreign tax credit ordering rules with the investment tax credit ordering rules.

A FIFO rule for foreign tax credit utilization, however, would be inconsistent with the matching principle inherent in the foreign tax credit system. Under a FIFO rule, foreign taxes paid in earlier years would be credited against pre-credit U.S. tax on later-year income before the foreign taxes actually paid on the later-year income would be credited. Thus, the matching of current foreign tax credits with the pre-credit U.S. tax on the current income that gave rise to the credits would be eliminated to the extent that credit carryovers equaled or exceeded the pre-credit U.S. tax.

As previously noted, the matching principle has no apparent relevance to the investment tax credit. In addition, the Congress adopted a FIFO ordering rule for the investment tax credit because it was concerned that the desire of taxpayers to use credit carryovers as quickly as possible could significantly dampen the stimulative effect of the credit on new investments. Taxpayers, the Congress concluded, might have made fewer new investments if required use of the credits for new investments before older carryover credits caused the taxpayers to lose the carryover credits.

Proponents of the adoption of a FIFO ordering rule (and the extension of the carryover period) for foreign tax credits argue, on the other hand, that the matching of current foreign tax credits for foreign taxes paid on current income with the pre-credit U.S. tax otherwise due on that income is already imprecise under present law because of the mandatory use of the overall limitation. Under the overall limitation, foreign taxes paid in a particular foreign country are not matched, for crediting purposes, with the pre-credit U.S. tax due on the income earned in that foreign country, as they would be under a per-country limitation.

4. S. 1814—Senator Packwood

Deduction for Loss in Value of Bus Operating Authorities

Background

Prior to enactment of the Bus Regulatory Reform Act of 1982, intercity bus operators were required to obtain a bus operating authority before providing service on a particular route. Only a limited number of bus-operating authorities were issued. Persons wishing to enter a route often purchased an existing business that already owned an operating authority, and substantial amounts were paid for these operating authorities. Thus, the value of bus operating rights constituted a substantial part of a bus operator's assets and a source of loan collateral.

The 1982 statute, in deregulating intercity buses, allows intercity bus operators to enter on, expand, drop, or change routes, free of Federal barriers. As a result of the relative ease of entry into the intercity bus business, the value of bus operating authorities has diminished significantly.

The owners of bus operating authorities state that their situation is similar to that faced by owners of motor carrier operating authorities after enactment of the Motor Carrier Act of 1980. That statute deregulated the trucking industry; as a result, motor carrier operating authorities lost significant value. In the Economic Recovery Tax Act of 1981, the Congress enacted a provision allowing trucking companies an ordinary deduction ratably over five years for loss in value of motor carrier operating authorities (sec. 266 of the 1981 Act).

Present Law

A deduction is allowed for any loss incurred in a trade or business during the taxable year, if the loss is not compensated for by insurance or otherwise (Code sec. 165(a)). In general, the amount of the deduction equals the adjusted basis of the property giving rise to the loss (sec. 165(b)). Treasury regulations provide that, to be deductible, a loss must be evidenced by a closed and completed transaction (i.e., must be "realized"), and must be fixed by an identifiable event (Treas. Reg. sec. 1.165-1(b)).

As a general rule, no deduction is allowed for a decline in value of property absent a sale, abandonment, or other disposition. Thus, for a loss to be allowed as a deduction, generally the business must be discontinued or the property must be abandoned (Treas. Reg. sec. 1.165-2)). Further, if the property is a capital asset and is sold or exchanged at a loss, the deduction of the resulting capital loss is subject to limitations (secs. 1212, 1211, and 165(f)).

The courts have denied a loss deduction where the value of an operating permit or license decreased as the result of legislation expanding the number of licenses or permits that could be issued. In the view of several courts,[1] the diminution in the value of a license or permit does not constitute an event giving rise to a deductible loss if the license or permit continues to have value as a right to carry on a business.

Explanation of the Bill

The bill would allow an ordinary deduction ratably over a 60-month period for taxpayers who held one or more bus operating authorities on November 19, 1982 (the date of enactment of the Bus Regulatory Reform Act of 1982). The amount of the deduction would be the aggregate adjusted bases of all bus operating authorities that were held by the taxpayer on November 19, 1982, or acquired after that date under a contract that was binding on that date.

The 60-month period would begin with the later of November 1, 1982, or, at the taxpayer's election, the first month of the taxpayer's first taxable year beginning after that date. The bill would require that adjustments be made to the bases of authorities to reflect amounts allowable as deductions under the bill.

Under regulations to be prescribed by the Treasury, a taxpayer (whether corporate or noncorporate) holding an eligible bus operating authority would be able to elect to allocate to the authority a portion of the cost to the taxpayer of stock in an acquired corporation. The election would be available if the bus operating authority was held (directly or indirectly) by the taxpayer at the time its stock was acquired. In such a case, a portion of the stock basis would be allocated to the authority only if the corporate or noncorporate taxpayer would have been able to make such an allocation had the authority been distributed in a liquidation to which prior-law section 334(b)(2) applied. The election would be available only if the stock was acquired on or before November 19, 1982 (or pursuant to a binding contract in effect on such date).

Effective Date

The provision would be effective retroactively for taxable years ending after November 18, 1982.

---

[1] *See, e.g., Consolidated Freight Lines, Inc.* v. *Comm'r,* 37 B.T.A. 576 (1938), *aff'd,* 101 F.2d 813 (9th Cir.), *cert. denied,* 308 U.S. 562 (1939) (denial of loss deduction attributable to loss of monopoly due to State deregulation of the intrastate motor carrier industry); *Monroe W. Beatty,* 46 T.C. 835 (1966) (no deduction allowed for diminution in value of liquor license resulting from change in State law limiting grant of such licenses).

5. S. 1815—Senator Packwood

Exemption for Certain Title-Holding Corporations

Present Law

Under present law, a corporation that is organized for the exclusive purpose of holding title to property, collecting income therefrom, and distributing the income (less expenses) to a tax-exempt organization is itself exempt from Federal income tax (Code sec. 501(c)(2)). The Internal Revenue Service has taken the position, in General Counsel Memorandum,[1] that this provision means that the title-holding corporation may distribute income only to one or more related tax-exempt organizations.

Most organizations that are exempt from Federal income taxation generally are subject to tax on any unrelated trade or business taxable income (secs. 511-513). The term unrelated trade or business generally means any trade or business the conduct of which is not substantially related to the exercise or performance by the tax-exempt organization of the activities for which the organization was granted tax exemption. In general, the rental of real property by a tax-exempt organization does not give rise to unrelated business taxable income (sec. 512(b)(3)).

Present law also provides that income of an exempt organization from debt-financed property (unless the use of the property itself is substantially related to the organization's exempt function) is subject to the unrelated business income tax in the proportion in which the property is financed by the debt (sec. 514). Debt-financed property means all property (including rental real estate, tangible personal property, and corporate stock) that is held to produce income and with respect to which indebtedness was incurred to acquire or improve the property or would not have been incurred but for the acquisition or improvement of the property.

However, a special rule applies under present law to real property acquired by a tax-exempt trust forming part of a tax-qualified pension, profit-sharing, or stock bonus plan (sec. 514(c)(9)). Under this rule, debt-financed real property acquired by the exempt trust is not treated as debt-financed property unless one of five exceptions to the rule applies.

Explanation of the Bill

The bill would exempt from Federal income tax any corporation organized exclusively to acquire, hold title to, and collect income from property and turn over all income (less expenses) from the property to one or more qualifying organizations, whether or not related. For this purpose, qualifying organizations would be defined as (1) a qualified pension, etc., plan (Code sec. 401(a)); (2) a governmental plan (sec. 414(d)); (3) the United States, any State or political subdivision, or any agency or instrumentality of such a governmental unit; or (4) a charitable organization (sec. 501(c)(3)).

---

[1] *E.g.*, G.C.M. 37351, December 20, 1977.

In addition, for purposes of the special rule under present law relating to debt-financed property, the bill would treat the title-holding corporation the same as an exempt trust forming part of a qualified pension, etc., plan.

Effective Date

The bill would be effective for taxable years beginning after December 31, 1983.

6. S. 1826—Senator Danforth

"Hunger Relief Incentives Tax Act of 1983"

Present Law

General rule

In general, the amount of charitable deduction otherwise allowable for donated property must be reduced by the amount of any ordinary gain which the taxpayer would have realized had the property been sold for its fair market value on the date of the donation (Code sec. 170(e)). Thus, a donor of inventory or other ordinary-income property (property the sale of which would not give rise to long-term capital gain) generally may deduct only the donor's basis in the property, rather than its full fair market value. In the case of property used in the taxpayer's trade or business, the charitable deduction must be reduced by the amount of depreciation recapture which would be recognized on the sale of the donated property.

Under present law, no deduction is allowed for the value of services donated to a charitable organization. However, a taxpayer may deduct unreimbursed out-of-pocket expenses (such as fuel costs) incurred incident to the rendition of such services (Treas. Reg. sec. 1.170A-1(g)).

Special contributions rule

Under a special rule enacted in 1976, corporations (other than subchapter S corporations) are allowed an augmented charitable deduction for contributions of certain types of ordinary income property donated for the care of the needy, the ill, or infants (sec. 170(e)(3)).[1]

To qualify for this augmented charitable deduction, a contribution of ordinary income property must satisfy the following requirements:

(1) The donee must be a public charity (other than a governmental unit) or a private operating foundation;

(2) The donee must use the property in a use related to the donee's tax-exempt purpose and solely for the care of the ill, the needy, or infants;

(3) The property must be inventory property (within the meaning of sec. 1221(1)) or property used in the donor's trade or business (within the meaning of sec. 1221(2));

(4) The donee must not transfer the property in exchange for money, other property, or services; however, Treasury regulations

---

[1] Under a special rule enacted in 1981, an augmented charitable deduction also is allowed for corporate contributions of newly manufactured scientific equipment or apparatus to a college or university for research use in the physical or biological sciences (sec. 170(e)(4)).

permit the donee to charge a fee to another organization in connection with its transfer of the donated property, if the fee is small or nominal in relation to the value of the transferred property, is not determined by the value of the property, and is designed to reimburse the donee for its administrative, warehousing, or other similar costs;[2]

(5) The donor must receive a statement from the donee representing that the donee's use and disposition of the property will comply with requirements (2) and (4) above; and

(6) The property must satisfy the relevant requirements of the Federal Food, Drug, and Cosmetic Act in effect on the date of transfer and for 180 days prior to such transfer.

If all these requirements are satisfied, the augmented charitable deduction allowed for the contribution generally equals the sum of (1) the donor's basis in the donated property and (2) one-half of the unrealized appreciation. However, in no event is a deduction allowed for an amount which exceeds twice the basis of the property. Also, no deduction is allowed for any part of the unrealized appreciation which would have been ordinary income (if the property had been sold) because of the application of the recapture provisions relating to depreciation, mining exploration expenditures, excess farm losses, soil and water conservation expenditures, and land-clearing expenditures.

Explanation of the Bill

The bill would expand in several respects the special augmented charitable deduction rule for property donated for the care of the needy, the ill, or infants.

Eligible donees

The bill would expand the category of eligible donees to include governmental units (as defined in Code sec. 170(c)(1)).[3] Generally, the bill would not otherwise affect donee eligibility under present law.[4]

Contributions of food

The bill would provide that, in the case of a charitable contribution of food that otherwise qualifies for the augmented charitable deduction, the contribution will not be disqualified solely because the donor is not a corporation, if the donor is actively engaged in the trade or business of production or wholesale or retail marketing of food.[5]

In addition, the bill would provide that contributions of food which a donee has removed from the donor's fields ("gleaning") would be treated as qualified contributions. Under the bill, a contribution of food could qualify for the augmented deduction in spite of the donee's charging a fee to the ill or needy individuals or infants who receive the property, if the fee is small or nominal in relation to the value of the transferred property and is not determined by the property's value, and the fee is designed to reimburse the donee for its administrative, warehousing, or similar costs.

---

[2] Treas. Reg. sec. 1.170A-4A(b)(3)(ii).

[3] In accordance with this change, the use requirement for donated property would be amended to allow use related to the donee's governmental purpose or function.

[4] Under the bill, donee eligibility other than in the case of governmental units would be defined by reference to Code secs. 170(c)(2) and 501(a) rather than, as under present law, by reference to Code secs. 501(c)(3) and 501(a).

[5] Food, for these purposes, would be defined as any agricultural product which is intended for, and at the date of contribution is suitable for, human consumption, and which is not subject to the Federal excise taxes on alcohol or tobacco.

Contributions of transportation services

The bill would expand the category of qualified contributions to include certain charitable contributions by a taxpayer of transportation services for the movement of food. Such contributions would qualify if the food itself is a qualified contribution, the taxpayer receives from the donee of the food a written statement representing that the property being moved is a qualified contribution, and the taxpayer is either actively engaged in the trade or business of providing transportation services or is the donor of the property.

Amount of deduction

In the case of a qualified contribution by a taxpayer of transportation services, the bill would provide that the amount of the deduction is the fair market value of services contributed, but not to exceed the lesser of (1) twice the taxpayer's incremental direct costs incurred in providing the services or (2) such direct costs plus one-half of any gain the taxpayer would have realized if the services had been provided by the taxpayer at their fair market value.

In the case of a qualified contribution of food by a donor which is not required to and does not use inventories to compute taxable income (e.g., farmers on the cash basis of accounting for tax purposes), the bill would provide that the amount of the deduction is 50 percent of the gross receipts the donor would have realized if the food had been sold in the ordinary course of the donor's business.[6] This rule would apply both to noncorporate donors of food (to whom the bill extends eligibility for the augmented charitable deduction) and corporate donors of food (who are eligible donees under present law).

In the case of all other qualified contributions, the amount of the augmented charitable deduction would be computed as under present law.

Effective Date

The amendments made by the bill would be effective for qualified contributions made after the date of enactment.

---

[6] Absent this rule, donors making qualified contributions of food who are not required to use inventories to compute taxable income could be disadvantaged under the general deduction computation rule of Code sec. 170(e)(3), under which the amount of the deduction generally equals the sum of (1) the donor's basis in the donated property and (2) one-half of the unrealized appreciation, because such donors generally would have no basis in the contributed food.

O

II

98TH CONGRESS
1ST SESSION

S. 120

To extend for two years the allowance of the deduction for eliminating architectural and transportation barriers to the handicapped and elderly.

IN THE SENATE OF THE UNITED STATES

JANUARY 26 (legislative day, JANUARY 25), 1983

Mr. DOLE introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To extend for two years the allowance of the deduction for eliminating architectural and transportation barriers to the handicapped and elderly.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subsection (c) of section 2122 of the Tax Reform Act of 1976 (relating to the effective date for allowance of the deduction barriers to the handicapped and elderly) is amended by striking out "January 1, 1983" and inserting in lieu thereof "January 1, 1985".

○

98TH CONGRESS
1ST SESSION

S. 1397

To amend the Internal Revenue Code of 1954 to provide an alternative test for qualification for the credit for rehabilitated buildings.

IN THE SENATE OF THE UNITED STATES

MAY 26 (legislative day, MAY 25), 1983

Mr. DANFORTH (for himself and Mr. EAGLETON) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to provide an alternative test for qualification for the credit for rehabilitated buildings.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. ALTERNATIVE TEST FOR DEFINITION OF QUALIFIED REHABILITATED BUILDING.—Subparagraph (A) of section 48(g)(1) is amended by adding at the end thereof the following new clause:

"(iv) the requirement in clause (iii) shall be deemed to be satisfied if in the rehabilitation process:

(I) 50 percent or more of the existing external walls are retained in place as external walls;

(II) 75 percent or more of the existing external walls are retained in place (but not necessarily as external walls); and

(III) 95 percent of the existing internal structural framework is retained in place.

SEC. 2. EFFECTIVE DATE.—The amendments made by this section shall be effective for qualified rehabilitation expenditures incurred after May 26, 1983.

○

II

98TH CONGRESS
1ST SESSION

S. 1584

To amend the Internal Revenue Code of 1954 to conform the treatment of overall domestic losses with the treatment of overall foreign losses and to conform the foreign tax credit carryover and ordering rules with similar investment credit rules.

IN THE SENATE OF THE UNITED STATES

JUNE 29 (legislative day, JUNE 27), 1983

Mr. DANFORTH introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to conform the treatment of overall domestic losses with the treatment of overall foreign losses and to conform the foreign tax credit carryover and ordering rules with similar investment credit rules.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; ETC.

(a) SHORT TITLE.—This Act may be cited as the "Foreign Tax Credit Conformity Act of 1983".

(b) AMENDMENT TO 1954 CODE.—Whenever in this Act an amendment is expressed in terms of an amendment to, or an insertion in, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. RECAPTURE OF OVERALL DOMESTIC LOSS.

(a) IN GENERAL.—Subsection (f) of section 904 (relating to limitation on foreign tax credit) is amended by substituting in lieu of the title and paragraphs (1) and (2) thereof the following new title and new paragraphs (1) and (2);

"(f) RECAPTURE OF OVERALL FOREIGN AND DOMESTIC LOSSES.—

"(1) OVERALL FOREIGN LOSS.—

"(A) IN GENERAL.—For purposes of this subpart and section 936, in the case of any taxpayer who sustains an overall foreign loss for any taxable year, that portion of the taxpayer's taxable income from sources without the United States for each succeeding taxable year which is equal to the lesser of—

"(i) the amount of such loss (to the extent not used under this paragraph in prior taxable years), or

"(ii) 50 percent (or such larger percent as the taxpayer may choose) of the taxpayer's taxable income from sources without the

United States for such succeeding taxable year,

shall be treated as income from sources within the United States (and not as income from sources without the United States).

"(B) OVERALL FOREIGN LOSS DEFINED.—For purposes of this subsection, the term 'overall foreign loss' means the amount by which the gross income for the taxable year from sources without the United States (whether or not the taxpayer chooses the benefits of this subpart for such taxable year) for such year, including the amount, if any, that is treated as income from sources without the United States for such taxable year under paragraph (2), is exceeded by the sum of the deductions properly apportioned or allocated thereto, except that there shall not be taken into account—

"(i) any net operating loss deduction allowable for such year under section 172(a), and

"(ii) any—

"(I) foreign expropriation loss for such year, as defined in section 172(h), and

"(II) loss for such year which arises from fire, storm, shipwreck, or other casualty, or from theft,

to the extent such loss is not compensated for by insurance or otherwise.

"(2) Overall domestic loss.—

"(A) In general.—For purposes of this subpart and section 936, in the case of any taxpayer who sustains an overall domestic loss for any taxable year, that portion of the taxpayer's taxable income from sources within the United States for each succeeding taxable year which is equal to the lesser of—

"(i) the amount of such loss (to the extent not used under this paragraph in prior taxable years), or

"(ii) 50 percent (or such larger percent as the taxpayer may choose) of the taxpayer's taxable income from sources within the United States for such succeeding taxable year,

shall be treated as income from sources without the United States (and not as income from sources within the United States).

"(B) OVERALL DOMESTIC LOSS DEFINED.—For purposes of this subsection, the term 'overall domestic loss' means the amount by which the gross income for the taxable year from sources within the United States for such year, including the amount, if any, that is treated as income from sources within the United States for such taxable year under subparagraph (1), is exceeded by the sum of the deductions properly apportioned or allocated thereto, to the extent such loss offsets income from sources without the United States for the taxable year, except that there shall not be taken into account any loss for such year which arises from fire, storm, shipwreck, or other casualty, or from theft, to the extent such loss is not compensated for by insurance or otherwise.".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to taxable years beginning after December 31, 1981.

SEC. 3. EXTENDED CARRYOVER PERIOD FOR EXCESS FOREIGN TAX CREDITS; ORDERING RULE FOR FOREIGN TAX CREDIT.

(a) CARRYOVER PROVISION FOR EXCESS CREDITS ARISING IN 1979 THROUGH 1981.—Subsection (c) of section 904 is amended by inserting at the end thereof the following new sentence: "In the case of an amount deemed by this subsection to be an excess tax paid with respect to a taxable year beginning after December 31, 1978, and ending before January 1, 1982, the first sentence of this subsection shall be applied by substituting 'in each of the 15 succeeding taxable years' for 'in the first, second, third, fourth or fifth succeeding taxable years,' in the first sentence.".

(b) CARRYOVER AND ORDERING RULE PROVISIONS FOR CREDITS ARISING AFTER 1981.—Subsection (a) of section 904 is amended to read as follows:

"(a) GENERAL RULE.—

"(1) FIRST-IN-FIRST-OUT RULE.—The amount of the credit allowed by section 901(a) shall be an amount equal to the sum of—

"(A) the foreign tax credit carryovers carried to such taxable year,

"(B) the amount of the credit determined under section 901(a) for such taxable year, plus

"(C) the foreign tax credit carrybacks carried to such taxable year,

and subject to the limitations imposed by paragraphs (2), (3), (4) and (5). The credits allowable under subparagraph (A) shall be used before the credits allowable under subparagraphs (B) and (C), and the credits allowable under subparagraphs (A) and (B) shall be used before the credits allowable under subparagraph (C).

"(2) LIMITATION IN TAXABLE YEAR.—The total amount of credit taken under section 901(a) in paragraph (1) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year. For purposes of the preceding sentence, in the case of an individual, the entire taxable income shall be reduced by an amount equal to the zero bracket amount.

"(3) CARRYBACK AND CARRYOVER OF EXCESS TAX PAID.—If the sum of the amount of the foreign tax credit carryovers to the taxable year under paragraph (1)(A) plus the amount determined under paragraph (1)(B) for the taxable year exceeds the amount of the limitation imposed by paragraph (2) for such taxable year (hereinafter in this subsection referred to as the 'unused credit year'), such excess attributable to the amount determined under paragraph (1)(B) shall be—

"(A) a foreign tax credit carryback to each of the 2 taxable years preceding the unused credit year, and

"(B) a foreign tax credit carryover to each of the 15 taxable years following the unused credit year and,

subject to the limitations imposed by paragraphs (4) and (5), shall be taken into account under the provisions of paragraph (1) in the manner provided in such paragraph. The entire amount of the unused credit for an unused credit year shall be carried to the earliest of the 17 taxable years to which (by reason of subparagraphs (A) and (B)) such credit may be carried and then to each of the other 16 taxable years to the extent, because of the limitations imposed by paragraphs (4) and (5), such unused credit may not be taken into account under paragraph (1) for a prior taxable year to which such unused credit may be carried.

"(4) LIMITATION ON CARRYBACKS.—The amount of the unused credit which may be taken into account under paragraph (1)(C) for any preceding taxable year shall not exceed the amount by which the limitation imposed by paragraph (3) for such taxable year exceeds the sum of—

"(A) the amounts determined under paragraphs (1)(A) and (1)(B) for such taxable year, plus

"(B) the amounts which (by reason of this subsection) are carried back to such taxable year and are attributable to taxable years preceding the unused credit year.

"(5) LIMITATION ON CARRYOVERS.—The amount of the unused credit which may be taken into account under paragraph (1)(A) for any succeeding taxable year shall not exceed the amount by which the limitation imposed by paragraph (3) for such taxable year exceeds the sum of the amounts which, by reason of this subsection, are carried to such taxable year and are attributable to taxable years preceding the unused credit year.".

(c) CONFORMING AMENDMENTS.—

(1) Subsection (c) of section 904 is repealed.

(2) Subsections (d), (e), and (f) of section 904 are redesignated as subsections (c), (d), and (e) respectively.

(d) EFFECTIVE DATES.—

(1) The amendment made by subsection (a) shall be effective upon enactment.

(2) The amendments made by sections (b) and (c) shall be effective with respect to taxable years beginning after December 31, 1981.

○

II

98th CONGRESS
1st Session

S. 1814

To amend the Internal Revenue Code of 1954 to allow an amortization deduction for bus-operating rights based on a 60-month period.

IN THE SENATE OF THE UNITED STATES

August 4 (legislative day, August 1), 1983

Mr. Packwood introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to allow an amortization deduction for bus-operating rights based on a 60-month period.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. DEDUCTION FOR BUS OPERATING AUTHORITY.

(a) General Rule.—For purposes of chapter 1 of the Internal Revenue Code of 1954, in computing the taxable income of a taxpayer who, on November 19, 1982, held one or more bus-operating authorities, an amount equal to the aggregate adjusted basis of all bus-operating authorities held by the taxpayer on November 19, 1982, or acquired subsequent thereto pursuant to a binding contract in effect on November 19, 1982, shall be allowed as a deduction ratably over a period of 60 months. Such 60-month period shall begin with the later of the month of November 1982 or the month in which acquired, or, if later, at the election of the taxpayer, the first month of the taxpayer's first taxable year beginning after November 19, 1982.

(b) DEFINITION OF BUS-OPERATING AUTHORITY.—For purposes of this section, the term "bus-operating authority" means—

(1) a certificate or permit held by a motor common or contract carrier of passengers and issued pursuant to subchapter II of chapter 109 of title 49 of the United States Code, or

(2) a certificate or permit held by a motor carrier authorizing the transportation of passengers over regular routes in intrastate commerce, and issued by the appropriate State agency.

(c) SPECIAL RULES.—

(1) ADJUSTED BASIS.—For purposes of the Internal Revenue Code of 1954, proper adjustments shall be made in the adjusted basis of any bus-operating authority for the amounts allowable as a deduction under this section.

(2) CERTAIN STOCK ACQUISITIONS.—

(A) IN GENERAL.—Under regulations prescribed by the Secretary of the Treasury or his delegate, and at the election of the holder of the authority, in any case in which a corporation—

(i) on or before November 19, 1982 (or after such date pursuant to a binding contract in effect on such date), acquired stock in a corporation which held, directly or indirectly, any bus-operating authority at the time of such acquisition, and

(ii) would have been able to allocate to the basis of such authority that portion of the acquiring corporation's cost basis in such stock attributable to such authority if the acquiring corporation had received such authority in the liquidation of the acquired corporation immediately following such acquisition and such allocation would have been proper under section 334(b)(2) of such Code,

the holder of the authority may, for purposes of this section, allocate a portion of the basis of the acquiring corporation in the stock of the acquired corporation to the basis of such authority in such manner as the Secretary may prescribe in such regulations. The preceding sentence shall not apply if an election under section 338 of such Code is in effect with respect to the corporation described in clause (i).

(B) TREATMENT OF CERTAIN NONCORPORATE TAXPAYERS.—Under regulations prescribed by the Secretary of the Treasury or his delegate, and at the election of the holder of the authority, in any case in which—

(i) a noncorporate taxpayer or group of noncorporate taxpayers on or before November 19, 1982, acquired in one purchase stock in a corporation which held, directly or indirectly, any bus-operating authority at the time of such acquisition, and

(ii) the acquisition referred to in clause (i) would have satisfied the requirements of subparagraph (A) if the stock had been acquired by a corporation,

then, for purposes of subparagraphs (A) and (C), the noncorporate taxpayer or group of noncorporate taxpayers referred to in clause (i) shall be treated as a corporation. The preceding sentence shall apply only if such noncorporate taxpayer (or group of noncorporate taxpayers) on November 19, 1982, held stock constituting control (within the meaning of section 368(c) of the Internal Revenue Code of 1954) of the corporation holding (directly or indirectly) the bus-operating authority.

(C) ADJUSTMENT TO BASIS.—Under regulations prescribed by the Secretary of the Treasury or his delegate, proper adjustment shall be made to the basis of the stock or other assets in the manner provided by such regulations to take into account any allocation under subparagraph (A).

(3) SECTION 381 OF THE INTERNAL REVENUE CODE OF 1954 TO APPLY.—For purposes of section 381 of the Internal Revenue Code of 1954, any item described in this section shall be treated as an item described in subsection (c) of such section 381.

(d) EFFECTIVE DATE.—The provisions of this section shall apply to taxable years ending after November 18, 1982.

○

II

98TH CONGRESS
1ST SESSION

S. 1815

To amend the Internal Revenue Code of 1954 to exempt from taxation corporations which acquire and manage real property for certain other exempt organizations, and for other purposes.

IN THE SENATE OF THE UNITED STATES

AUGUST 4 (legislative day, AUGUST 1), 1983

Mr. PACKWOOD introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to exempt from taxation corporations which acquire and manage real property for certain other exempt organizations, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 501(c) of the Internal Revenue Code of 1954 (relating to the list of exempt organizations) is amended by adding at the end thereof the following new paragraph:

"(24)(A) Any corporation organized for the exclusive purposes of—

"(i) acquiring property and holding title to, and collecting income from, such property, and

"(ii) turning over the entire amount of income from such property (less expenses) to one or more organizations described in subparagraph (C).

"(B) A corporation shall be described in subparagraph (A) without regard to whether the corporation is organized by one or more organizations described in subparagraph (C).

"(C) An organization is described in this subparagraph if such organization is—

"(i) any qualified pension, profit sharing, or stock bonus plan which meets the requirements of section 401(a),

"(ii) a governmental plan (within the meaning of section 414(d)),

"(iii) the United States, any State or political subdivision thereof, or any agency or instrumentality of any such governmental unit, or

"(iv) any organization described in paragraph (3).".

(b) Subparagraph (A) of section 514(c)(9) of the Internal Revenue Code of 1954 (relating to real property acquired by qualified trust) are amended by inserting "or an organization described in section 501(c)(24)" after "qualified trust".

(c) The amendments made by this section shall apply to taxable years beginning after December 31, 1983.

○

II

98TH CONGRESS
1ST SESSION

S. 1826

Entitled the "Hunger Relief Incentives Tax Act of 1983".

IN THE SENATE OF THE UNITED STATES

AUGUST 4 (legislative day, AUGUST 1), 1983

Mr. DANFORTH introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

Entitled the "Hunger Relief Incentives Tax Act of 1983".

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 170(e)(3) of the Internal Revenue Code of 1954 is amended to read as follows:

"(3) SPECIAL RULE FOR CERTAIN CONTRIBUTIONS OF INVENTORY AND OTHER PROPERTY.—

"(A) QUALIFIED CONTRIBUTIONS, IN GENERAL.—For purposes of this paragraph, a qualified contribution shall mean a charitable contribution of property described in paragraph (1) or (2) of section 1221, by a corporation (other than a corporation which is an electing small business corporation within the meaning of section 1371(b)) to an organization which is described in section 170(c)(1) or to an organization which is described in section 170(c)(2) and is exempt under section 501(a) (other than a private foundation, as defined in section 509(a), which is not an operating foundation, as defined in section 4942(j)(3)), but only if—

"(i) the use of the property by the donee is related to its governmental purpose or function or to the purpose or function constituting the basis for its exemption under section 501 and the property is to be used by the donee solely for the care of the ill, the needy, or infants;

"(ii) the property is not transferred by the donee in exchange for money, other property, or services;

"(iii) the taxpayer receives from the donee a written statement representing that its use and disposition of the property will be in accordance with the provisions of clauses (i) and (ii); and

"(iv) in the case where the property is subject to regulation under the Federal Food, Drug, and Cosmetic Act, as amended, such property must fully satisfy the applicable requirements of such Act and regulations promulgated thereunder on the date of transfer and for 180 days prior thereto.

"(B) SPECIAL RULE FOR CONTRIBUTIONS OF FOOD.—

"(i) IN GENERAL.—In the case of a charitable contribution of food, a contribution which otherwise meets the definition of a qualified contribution under subparagraph (A) shall not be disqualified solely because the taxpayer is not a corporation described in subparagraph (A), if such taxpayer is actively engaged in the trade or business of production or wholesale or retail marketing of food.

"(ii) DEFINITION OF FOOD.—For purposes of this subparagraph, the term 'food' shall mean any agricultural product which is intended for, and at the date of contribution is suitable for, human consumption, and which is not subject to the Federal excise tax on alcohol and tobacco under chapters 51 and 52 of the Internal Revenue Code.

"(iii) GLEANING.—For purposes of this subparagraph, a charitable contribution of food shall include contributions of food which a donee organization described in subparagraph (A) has removed from the taxpayer's fields, if the contribution otherwise meets the definition of a qualified contribution under subparagraph (A).

"(iv) Notwithstanding any other provision, a contribution of food may qualify under this paragraph in spite of the donee-organization charging a fee to the ill or needy individuals or infants who receive the property from such organization, if the fee is small or nominal in relation to the value of the transferred property and is not determined by its value, and the fee is designed to reimburse the donee-organization for its administrative, warehousing, or similar costs.

"(C) SPECIAL RULE FOR CONTRIBUTIONS OF CERTAIN TRANSPORTATION SERVICES.—For purposes of this paragraph, a qualified contribution shall include the charitable contribution by a taxpayer of transportation services for the movement of food which is described in subparagraph (A) or (B), but only if—

"(i) the taxpayer receives from the donee a written statement representing that the property being moved is a qualified contribution, as defined in this paragraph, and

"(ii) the taxpayer is actively engaged in the trade or business of providing such services, or is the donor of such property.

"(D) AMOUNT OF DEDUCTION.—The deduction under subsection (a) for any qualified contribution (as defined in this paragraph) shall be—

"(i) except as provided in clause (ii), in the case of a qualified contribution described in subparagraph (A) or (B), determined by limiting the reduction under paragraph (1)(A) to the sum of—

"(a) one-half of the amount computed under paragraph (1)(A) (computed without regard to this paragraph), and

"(b) the amount (if any) by which the charitable contribution deduction under this section for any qualified contribution (computed by taking into account the amount determined in subclause (a), but without regard to this subclause) exceeds twice the basis of such property.

"(ii) in the case of a qualified contribution of food, by a taxpayer which is not required to and does not use inventories to compute taxable income, 50 percent of the gross receipts the taxpayer would have realized if such food had been sold in the ordinary course of the taxpayer's business.

"(iii) in the case of a qualified contribution described in subparagraph (C), the least of—

"(a) the fair market value of the services contributed,

"(b) twice the incremental direct costs incurred by the taxpayer in providing the services, or

"(c) such direct costs, added to one-half the amount of gain the taxpayer would have realized if the services contributed had been provided by the taxpayer at their fair market value.

"(E) This paragraph shall not apply to so much of the gain described in paragraph (1)(A) which would be long-term capital gain but for the application of sections 617, 1245, 1250, 1251, or 1252."

(b) EFFECTIVE DATE.—The amendments made by this legislation shall be effective for qualified contributions made after the date of enactment.

○

Senator PACKWOOD. The hearing will come to order.

Good morning. We will start off this morning with the Deputy Assistant Secretary for Tax Policy, Mr. Pearlman.

Mr. Pearlman, I've got your whole statement. You must comment on all of the bills before us, but if you could abbreviate it, I would appreciate it.

Mr. PEARLMAN. I will try to do that. I apologize if we have held you up, Mr. Chairman. I am not going to read the statement, but I would like to comment on each of the bills.

STATEMENT OF HON. RONALD A. PEARLMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Mr. PEARLMAN. I am pleased to be here this morning to testify on these six bills, to offer the Treasury Department's views. What I would like to do is briefly go through each one and refer to my prepared statement for the details.

The first bill, Senate bill 120, provides for a deduction for the elimination of architectural and transportation barriers to the handicapped and the elderly. This provision would reenact, if you will, section 190 of the Internal Revenue Code that was originally enacted in 1976 to provide an elective deduction of up to $25,000 per year for expenses that otherwise would be capitalized to remove architectural and transportation barriers.

The section expired in December 1982, and Senate bill 120 would reinstate section 190 for taxable years beginning before January 1, 1985.

The Treasury Department supports Senate bill 120. The administration is strongly supportive of efforts to increase the opportunities for the handicapped and elderly persons. We think the extension provided in Senate bill 120 will contribute to the increase of these opportunities by continuing the incentive for owners of real property and transportation equipment to remove these barriers.

Since the information on the extent to which section 190 was utilized is inadequate, we do not know the effectiveness of section 190, but hopefully the extension will give us some time to gather further information and consider alternatives to encourage removal of these barriers.

The second bill, Senate bill 1397, modifies the current income tax credit for qualified rehabilitation expenditures.

Under current law, a tax credit is available for certain expenditures incurred in the rehabilitation of historic structures. In order to qualify for the credit, expenditures must be incurred in connection with a qualified rehabilitated building. Among the conditions that must be met to qualify as a qualified rehabilitated building is that at least 75 percent of the existing external walls must be retained in place as external walls.

In some cases, although the external walls are retained in place, because of the addition of new construction one or more of these walls may become interior walls and the building will not meet the 75-percent test. And yet, in spite of these variations, in many of these cases the objective of the statute is being met.

Senate bill 1397 expands the current definition of a qualified rehabilitated building to provide an alternative test to the present 75 percent test. The alternative test would be satisfied if at least 50 percent of the existing external walls are retained in place as external walls, 75 percent of the external walls are retained in place even though they may not all be external walls, and 95 percent of the existing internal framework is retained in place.

We think that this alternative test is consistent with and a furtherance of the original congressional objective to assure substantial retention and rehabilitation of existing buildings while facilitating the rehabilitation process, and, therefore, we support S. 1397.

Senate bill 1584 is entitled the "Foreign Tax Credit Conformity Act of 1983." It would make three basic changes in the rules applicable to the foreign tax credit, all related to the carryover of unused credits.

Under current law, U.S. taxpayers are allowed a credit against U.S. tax for certain taxes paid to a foreign jurisdiction on the taxpayer's foreign source income. The credit assures that the taxpayer does not suffer a double tax on the income earned in a foreign country by reason of that country's tax on the income and the U.S. tax on the taxpayer's worldwide income.

In general, the credit is available only to the extent the taxpayer includes foreign source income in income in a taxable year. To the extent the credit cannot be utilized in a particular year, for example, because the taxpayer's overall taxable income does not produce a tax sufficient to fully absorb the credit, it will then under current law carryback 2 years and forward 5 years.

Senate bill 1584 is designed to deal with a situation in which a taxpayer earns foreign source income and pays a foreign tax, thereby qualifying the taxpayer for the foreign tax credit; but because of domestic losses which offset all or a part of the foreign source income, the foreign tax credit is not fully utilized.

This situation inevitably will occur on occasion, but apparently has occurred more frequently during the past several years as various segments of U.S. industry have incurred domestic losses while earning income abroad.

To understand the operation of Senate bill 1584, a simple example might be helpful. The example is contained, Mr. Chairman, in our written statement.

Assume in year 1 the taxpayer incurs a domestic loss of $100, a foreign profit of $100, and pays a foreign tax at a 46-percent rate on that foreign profit. In year 2, the taxpayer has both a $100 domestic profit and foreign profit and pays another $46 of foreign tax. In year 1 the domestic loss of $100 offsets the foreign income in determining the taxpayer's worldwide income, providing zero overall taxable income, zero U.S. tax, and the unused foreign tax credit carries over. In year 2, although the taxpayer has $200 of taxable income and $92 of U.S. tax—assuming a 46-percent rate—only the year 2 foreign tax credit is available to reduce the tax. The foreign tax credit carryover is not available because of the application of the foreign tax credit limitation; that is, the foreign tax credit is available in a particular year only to the extent of the foreign source taxable income of that year.

This example illustrates the operation of two principles of U.S. tax law as applicable to the foreign area: First, that worldwide income is combined in determining taxable income, so that even though the taxpayer in year 1 incurs foreign source income and pays a foreign tax, the domestic loss offsets the foreign source income and thereby renders the foreign tax credit unavailable.

The second principle is that we apply the foreign tax credit limitation on a year-by-year or annual accounting basis.

Senate bill 1584 seeks to cure this apparent inequity in current law by a so-called domestic loss recapture. Under the example, the bill would permit the recharacterization of the year-2 domestic income as foreign source income, to the extent the year-1 domestic loss offsets foreign source income.

By this recharacterization, the bill creates, if you will, sufficient foreign source income in year 2 to permit a full absorption of the foreign tax credit carry forward.

The bill's effective date is taxable years beginning after December 31, 1981.

The method utilized to correct this perceived problem is analagous to the so-called foreign loss recapture provision added to the code in 1976 as section 904(f). It is designed to preclude a perceived double tax benefit when a foreign loss in one year offsets domestic income in another year in a situation where, in the second year there is foreign income, yet the foreign income is not offset by the foreign loss because under the foreign tax system in question a net operating loss carryforward is not available.

In reviewing this aspect of Senate bill 1584, we think it is important to consider the following:

First, whether the facts described in the example that I noted and that is contained in our statement, do in fact create a legitimate problem justifying a cure. We are inclined to answer this question in the affirmative but have some concern that a literal and perhaps proper reading of the foreign tax credit rules would answer this question in the negative. The purpose of the foreign tax credit is to avoid a double tax on the foreign-source income, and in the example there is clearly no double tax on the foreign-source income in year 1 even though the foreign tax credit in year 1 is not utilized.

The second question is whether the existence of section 904(f), which operates to prevent a perceived double tax benefit in the foreign loss situation, by its enactment argues for a legislative solution to the domestic loss situation. Again, we are inclined to answer this question yes; although we are concerned about the unintended effects of the rule, several of which are discussed in our written statement.

In spite of our sympathy for the purpose and the structure of the domestic loss recapture rule, we are unable to support the proposal for two reasons:

First, I do not want to be accused of breaching the Treasury Department's tradition of not supporting three bills in a row; and second, and more seriously, our preliminary revenue estimates indicate that a large volume of losses and excess credits, which the proposal will make available for utilization, will produce a substantial revenue cost over the period 1984 through 1988. At a time of fiscal restraint and taking into consideration the current problem with budget deficits, we simply cannot support a proposal with a potentially substantial revenue loss.

I should note that we also object to a 1982 effective date, because we believe retroactive legislation as a matter of tax policy is unsound.

I would like to comment just very briefly on the other two aspects of Senate bill 1584.

The first would extend the foreign tax credit carryforward period from 5 to 15 years. For the reasons that I have set out more fully in my statement, we are not convinced that an extension of the carry-forward period is consistent with the congressional intent in establishing the carryover of the foreign tax credit in 1958.

Should the subcommittee determine that an extension of the carry-forward period is consistent with its original purpose, we would be pleased to work with the subcommittee in trying to determine an appropriate period consistent with this objective.

As with the recapture rule, however, we do not believe retroactive effective dates, in this case beginning after December 31, 1981, with respect to foreign tax credits arising in taxable years beginning after 1978, are desirable.

Finally, the bill would revise the present foreign tax credit ordering rule from a LIFO to a FIFO rule. We think this change is inconsistent with the general objective of matching as nearly as possible the foreign tax credit to the foreign source income which generated the credit, and for this reason we oppose that change.

Next I would like to comment on Senate bill 1814, which proposes to permit the amortization of losses arising form the easing of the regulation of inner-city bus rights. The bill would permit a 60-month amortization of the decline in value of bus operating authorities held on November 19, 1982, the date on which the Bus Regulatory Reform Act of 1982 was enacted.

We are opposed to Senate bill 1814 for the following reasons:

First, we do not believe the Bus Regulatory Reform Act eliminates the value of bus operating rights in their entirety, and we believe that, consistent with the general principles of tax law, that a mere decline in value is not an appropriate loss-deduction-amortization event.

Further, we do not support relief on a specific industry basis, when declines in value may well occur in other regulated industries. We acknowledge that Congress provided an amortization deduction for motor carrier operating authorities in the Economic Recovery Tax Act of 1981. We opposed that provision then, and we do not think it is sound tax policy to extend it now.

The fifth bill on which I would like to comment is Senate bill 1815, which would provide an exemption from tax for certain real estate investment corporations.

Current law provides tax exemption for so-called title holding companies, which are organized by a single tax-exempt organization to hold property for the benefit of certain tax-exempt organizations. Current law provides an exemption also in section 501(f) of the code for collective investment activities of exempt educational organizations.

Senate bill 1815 would exempt from tax a corporation organized as a collective real estate investment organization for the benefit of one or more exempt organizations.

We oppose Senate bill 1815 as drafted, but we support the general objective of authorizing a tax exempt vehicle which could serve to hold investments on a collective basis for more than one exempt organization. If the subcommittee chooses to proceed with this aspect of the bill we would be happy to work with you in developing a bill which we think more adequately meets the objectives.

Our principal objection to the bill as drafted is the provision that a for-profit organization could, through board membership, exercise effective control over investment decisions relating to the organization. We think it is desirable to assure that both ownership and control rests with the exempt organization beneficiary owners. And consistent with the legislative history of section 501(f), we urge that appropriate limits be imposed on the role of for-profit organizations.

We do not mean to suggest that investment advisers cannot play a proper role in an advisory capacity in the formation and in the operation of collective organizations, but we think their function should be appropriately limited to assure that they are in fact advisory.

We think it would be advisable to consider whether there are policy reasons for continuing in the statute the present section 501(f), which is limited to collective security investment funds for educational organizations, and Senate bill 1815, which is limited to real estate investments for a broader but nevertheless a limited group of exempt organizations. We think a better approach would probably be to articulate a single set of rules, pursuant to which exempt organizations can invest collectively on a uniform basis.

Senate bill 1815 would also exempt collective real estate investment corporations from the debt-financed property rules in the same way that debt-financed real estate investments of qualified pension trusts are presently exempted. We oppose this aspect of 1815. We believe there are sound policy reasons for the debt-financed property rules. They serve to assure that taxable sellers of property to the exempt fund are not indirectly receiving the benefit of the purchaser's tax-exempt status.

At the time the pension trust exemption was enacted, Congress made it clear that it thought pension trusts were different than other exempt organizations, and we are opposed to an extension of this exception which will only serve to weaken the force of the debt-financed property rules.

Finally, Mr. Chairman, I would like to comment on Senate bill 1826, the Hunger Relief Incentives Act of 1983.

Senate bill 1826 would change current law in several respects. Under current law, the Internal Revenue Code allows a deduction for certain gifts to exempt organizations of ordinary income property by corporations in an amount equal to the donor's basis in the property plus one-half of its value over basis, but not greater than two times its basis.

Senate bill 1826 would expand the deduction for certain ordinary income property by including Federal, State, and local governments as permissible donees, by permitting certain donors of food other than corporations to qualify for the increased deduction, by permitting the deduction for cash-basis taxpayers to be calculated on the basis of gross receipts rather than costs, and by permitting the donee organization to charge a nominal fee to the ultimate food recipient.

Senate bill 1826 would also permit an increased deduction for the transportation costs of donated food.

We oppose both aspects of Senate bill 1826. We cannot, of course, quarrel with the social desirability of providing food to needy persons or infants, but we do not think the tax laws are the way to do it. This increased deduction would constitute a Government expenditure, without any determination that this form of public assistance is preferable to other programs that suffer or die because of lack of funding.

We think the best determination of how to make Government funds available to provide food for the needy or for infants is through the direct appropriations process, where members of Congress and members of the administration responsible for public assistance programs, not members of the Department of Treasury or of the tax-writing committees, could make the determination as to the most efficient way to spend available funds for food.

We also oppose the proposal to increase the charitable contribution deduction for certain transportation costs. Currently, donors are eligible to deduct out-of-pocket costs for the contribution of services. There is no present exception to that rule. We think it would be inadvisable to create an exception which will only serve, in our opinion, to threaten the erosion of this long-established restriction.

For these reasons, Mr. Chairman, we oppose Senate bill 1826.

This concludes my remarks. I will be happy to attempt to answer your questions.

Thank you.

[The prepared statement of Mr. Pearlman follows:]

For Release Upon Delivery
Expected at 9:30 a.m., E.D.T.
September 26, 1983

STATEMENT OF
RONALD A. PEARLMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the following bills: S. 120 (relating to the allowance of a deduction for eliminating architectural and transportation barriers to the handicapped and the elderly); S. 1397 (relating to qualification for the tax credit of rehabilitation expenditures); S. 1584 (relating to the tax treatment of foreign losses and credit carryovers); S. 1814 (relating to amortization of certain bus-operating rights); S. 1815 (relating to the tax exemption of certain collective real property investment corporations); and S. 1826 (relating to the allowance of a deduction for charitable contributions of certain food and transportation).

The Treasury Department supports S. 120 and S. 1397, and opposes S. 1584, S. 1814, S. 1815, and S. 1826.

S. 120

Allowance of the Deduction for Eliminating Architectural and Transportation Barriers to the Handicapped and the Elderly

Background

Section 190 of the Internal Revenue Code, which expired on December 31, 1982, provided a tax incentive for the removal of architectural and transportation barriers to the handicapped and the elderly. Under section 190, a taxpayer could elect to deduct, rather than capitalize, up to $25,000 per year of expenses incurred to remove architectural and transportation barriers to the handicapped and the elderly. An expense is incurred to remove an architectural or transportation barrier to the handicapped and the elderly if it is incurred for the purpose of making any facility or public transportation vehicle owned or leased by the taxpayer for use in connection with his trade or business more accessible to, and usable by, handicapped or elderly individuals.

Section 190, as originally enacted as part of the Tax Reform Act of 1976, was effective for taxable years beginning after December 31, 1976 and before January 1, 1980. In 1979, the effective period for section 190 was extended by P.L. 96-167 to include taxable years beginning before January 1, 1983.

Description of S. 120

S. 120 would reinstate section 190 and extend the effective period to include taxable years beginning before January 1, 1985.

Discussion

Section 190 was enacted to encourage removal of architectural and transportation barriers to the handicapped and the elderly. The Senate Finance Committee Report on the Tax Reform Act of 1976 states that in spite of previous Federal legislation, such barriers remained widespread in business and industry. The tax incentive was created for a limited period of time to promote more rapid modification of business facilities and vehicles. It was expected that removal of architectural and transportation barriers would increase the involvement of the handicapped and the elderly in economic, social, and cultural activities.

The deduction allowed by section 190 does not appear as a separate line item on tax returns. For this reason, the Treasury Department does not have any information on the extent to which this provision has been utilized in the past. Information provided by groups interested in this provision indicates that many taxpayers were not aware of the incentive provided by section 190 and therefore did not take advantage of it. In view of the limited information available, it is difficult to determine the effectiveness and efficiency of section 190 in promoting removal of barriers to the handicapped and the elderly. We believe that more information is necessary to properly evaluate the effect of section 190 and that further consideration should be given to the most appropriate means for encouraging removal of barriers to the handicapped and the elderly.

This Administration, however, believes it is highly desirable to increase the opportunities for handicapped and elderly persons to participate in our society. Removal of architectural and transportation barriers to the handicapped and the elderly would greatly facilitate such participation and we support the two year extension of section 190 proposed in S. 120. During this time we hope to gain additional information on the effectiveness of section 190 and give further consideration to alternative methods for encouraging the removal of these barriers.

S. 1397

Qualification for the Tax Credit for Rehabilitation Expenditures

Background

The Internal Revenue Code provides an investment tax credit equal to 15, 20 or 25 percent of that portion of the basis of a building that is attributable to qualified rehabilitation expenditures. The purpose of the investment tax credit for rehabilitation expenditures is to encourage preservation and rehabilitation of historic buildings, to revitalize the economic prospects of older locations, and to prevent the decay and deterioration characteristic of economically distressed areas.

The conditions that must be met in order to qualify for the investment tax credit for rehabilitation expenditures are set forth in section 48(g) of the Code. In general, qualified rehabilitation expenditures are capital expenditures incurred in connection with the rehabilitation of a qualified rehabilitated building for property having a 15-year recovery period. In order to be a qualified rehabilitated building, a building must satisfy a number of criteria. In particular, a building must be substantially rehabilitated and 75 percent or more of the existing external walls of the building must be retained in place as external walls in the rehabilitation process. For purposes of the tax credit, rehabilitation includes reconstruction. However, new construction does not qualify as rehabilitation.

Description of S. 1397

S. 1397 would amend the definition of qualified rehabilitated building in section 48(g) to provide an alternative to the requirement that 75 percent or more of the existing external walls of a building be retained in place as external walls in the rehabilitation process. The alternative test would be satisfied if, in the rehabilitation process, 50 percent or more of the existing external walls are retained in place as external walls, 75 percent or more of the exisiting external walls are retained in place (but not necessarily as external walls), and 95 percent of the existing internal, structural framework is retained in place.

Discussion

We support S. 1397 because we believe it helps to carry out the intent of the Congress to provide credits for rehabilitation. For purposes of the investment tax credit for rehabilitation expenditures, new construction does not qualify as rehabilitation. The requirement under present law that 75 percent of the external walls of a building be retained as external walls during the rehabilitation process reflects the Congressional determination that construction costs should be treated as being for new construction rather than rehabilitation if more than 25 percent of the existing external walls of the building are replaced.

This 75 percent test appears in some cases to be overly restrictive. A building may fail to satisfy the 75 percent test where all external walls of a building are retained in place, but one or two external walls become interior walls because of additions made to the building. The construction relating to the addition to the building is clearly new construction, expenditures for which are not eligible for the tax credit. However, in many cases, expenditures related to the existing building would appear to be for rehabilitation rather than new construction.

We support the statutory scheme which provides an objective test for identifying certain projects that involve new construction rather than rehabilitation. We recognize that an objective standard results in arbitrary distinctions, and believe that the certainty provided by an objective rule justifies a certain degree of arbitrariness. It is appropriate, however, to reevaluate the impact of an objective test based on experience under the rule.

Some cases have arisen in which application of the 75 percent test to construction projects which include additions to buildings would prevent expenditures for rehabilitation of the original buildings from qualifying for the tax credit. We believe that the standards established by S. 1397 would permit true rehabilitation expenditures to qualify for the tax credit, and would continue to ensure that no credit would be allowed for projects where only an insignificant portion of an original building is retained in connection with new construction. Based on our view that the bill would result in better implementation of the Congressional purpose to allow credits for rehabilitations but not for new construction, we support S. 1397.

S. 1584

Foreign Tax Credit Conformity Act of 1983

Background

Foreign Tax Credit

Domestic corporations, U.S. citizens, and aliens resident in the United States are subject to tax on their worldwide income. When income is derived from sources outside the United States, it also may be subject to tax in the country in which it originates. Absent some relief, such income could be subject to taxation by both the country in which it originates and the United States, thereby resulting in double taxation of the same income. To avoid this result, the United States permits its taxpayers to elect to credit against their U.S. income tax foreign income taxes (or taxes in lieu thereof) paid to a foreign government.

The principle of the credit is that the country in which income originates has the primary right of taxation. If that income is derived by a resident of another country, the residence country also may tax such income. However, the residence country has the responsibility to avoid double taxation of that income by either exempting such income from taxation in the country of residence or, if it taxes income from both domestic and foreign sources, allowing a credit for the foreign income tax paid at source (the credit method).

Foreign Tax Credit Limitation

Absent a limitation, the credit method would not preclude foreign income taxes from offsetting U.S. tax on U.S. source income, as determined under U.S. principles. Since the United States has the primary right of taxation with respect to income derived from U.S. sources, U.S. law permits foreign income taxes to offset U.S. tax on foreign source income but not on U.S. source income. This restriction is called the foreign tax credit limitation.

During various periods of our history, the United States has required taxpayers to calculate their foreign tax credit limitation on a "per country" basis, or on an "overall basis". Sometimes we have required taxpayers to use the lower of the two limitations and sometimes we have allowed them to elect either the per country or the overall limitation. Since 1976, the overall limitation has been utilized.

The overall limitation is computed by multiplying the U.S. tax (before all credits) by a fraction, the numerator of which is foreign source taxable income and the denominator of which is taxable income from all sources. The amount of credit which may be taken in a particular year is the lesser of the (i) aggregate amount of income taxes paid or accrued to all foreign countries or (ii) the amount computed under the overall limitation. (For purposes of this computation, there are several categories of income with respect to which a separate foreign tax credit limitation calculation must be made. For example, the overall limitation must be computed separately for certain dividends from a DISC and certain investment interest income. Congress provided for the first separate limitation because it did not want taxpayers to use excess foreign tax credits on other foreign source income to offset U.S. income tax on DISC dividends because the taxpayer is already deferring a portion of the DISC's income. The investment interest income separate limitation was enacted to prevent taxpayers from depositing funds in foreign banks, thereby increasing their low tax foreign source income to make use of excess foreign tax credits.)

Carrybacks and Carryovers; Ordering

Excess foreign tax credits arising as a result of the application of the foreign tax credit limitation fraction generally may be carried back for two years and carried forward for five years and used as a credit to the extent there is an excess limitation in any of those years. However, carryovers are applied only after credits for foreign income taxes with respect to the current year have been utilized. The excess tax is applied first against any excess limitation of the second preceding year, then against any excess limitation of the first preceding year and is then carried forward to the first, second, and succeeding carryover years until fully credited or the expiration of the five year period.

Congress enacted the carryback and carryover of foreign tax credits to prevent double taxation which could occur "where the methods of reporting income are different in the United States and the foreign country." See H.R. Rep. No. 775, 85th Cong., 1st Sess. 27-28 (1957). Congress was specifically concerned with the differences resulting from the same income being reported in one year in the United States and in another year in the foreign country. Illustrations of potential timing differences given in the Ways and Means Committee Report accompanying the legislation include (i) the use of installment method reporting in the U.S. without a similar provision in the foreign country; (ii) differences in the pricing of inventories, thereby resulting in the reporting of income from the ultimate sale in different years; (iii) differences in depreciation methods; and (iv) the use of averaging devices in computing taxable income in certain foreign countries.

Losses and the Foreign Tax Credit

Inherent in the computation of any foreign tax credit limitation is the allocation and apportionment of deductions and losses. Deductions and losses are critical to the determination of worldwide taxable income and in the determination of the numerator and denominator of the foreign tax credit limitation fraction.

Assume that in 1983 a U.S. company generates a loss allocable to a foreign operation as a result of startup activities in a foreign country. The loss will reduce that corporation's worldwide income. Moreover, if such loss is in excess of foreign source income, it will reduce U.S. source income. If, in 1984, the foreign operation becomes profitable, the U.S. company can claim a credit for foreign income taxes imposed on such income in computing its U.S. tax liability. Prior to 1976, an anomalous result occurred in the case where, for example, the foreign country in which the loss was incurred had a tax rate equal to or less than the U.S. rate and did not have in its law a net operating loss carryover type provision; in such case, the U.S. taxpayer could receive a double tax benefit--the foreign loss would reduce its U.S. tax liability in the loss year and a foreign tax credit would be available in the profitable year.

The following illustrates the potential double tax benefit to taxpayers with foreign losses in excess of foreign income. Suppose that a foreign branch lost $100 in year 1, and then earned $100 in year 2. The first year loss was deductible against U.S. source income and thus reduced the amount of U.S. tax payable. Assuming a 46 percent tax rate, the net benefit flowing from the loss was $46. If, in year 2, the foreign branch paid an income tax to a foreign country of $46, that tax was fully creditable; the $100 profit in the second year would produce no net revenue to the United States because the credit for foreign taxes offset entirely the otherwise payable U.S. tax. In other words, when income was derived from that foreign country, the taxpayer would receive a credit for any income taxes paid on that income without any adjustment for the fact that the prior losses from that country previously had reduced its U.S. tax liability.

In response to this potential double tax benefit, Congress, in 1976, added section 904(f) to the Code. Under this provision a taxpayer who sustains losses allocable to foreign source income which are in excess of such income and thereby deductible against U.S. source income, in effect, may be required to reduce its foreign tax credits in later years when the taxpayer derives income from its foreign operations.

More specifically, recapture is accomplished by recharacterizing a portion of the taxpayer's foreign source taxable income as U.S. source income for purposes of the overall foreign tax credit limitation. The effect of this recharacterization is a possible reduction in the taxpayer's foreign tax credit limitation. Thus, in my previous example, the taxpayer suffered on overall foreign loss of 100 in year 1. This foreign loss creates a notional overall foreign loss (OFL) account. In year 2, when the taxpayer generated 100 of foreign source taxable income, to the extent of its overall foreign loss it must recharacterize a portion of that income as U.S. source income, thereby reducing the numerator of the foreign tax credit limitation fraction and the amount of allowable credit in that particular year.

The portion of foreign source income subject to recharacterization under section 904(f) is the lesser of the amount in the OFL account (to the extent the loss has not been recaptured in prior taxable years) or 50 percent of the foreign taxable income for that year, or some larger percent at the taxpayer's election. Thus, in our example at least $50 of the $100 of foreign income earned by the taxpayer in year 2 would be recharacterized as U.S. source income. Assuming that the taxpayer chooses to have 100 percent of his foreign income recharacterized as U.S. source income, none of the $46 of income tax paid by the foreign branch in year 2 would be creditable (and the taxpayer's OFL account would be reduced from $100 to 0). The net revenue effect to the United States therefore would be the same as it would have been if the foreign country had a provision in its law similar to that of the U.S. net operating loss carryover.

The intent of section 904(f) is to preclude a double tax benefit. However, the method adopted to achieve this objective is a departure from a fundamental principle in the foreign tax credit area--that of matching the foreign tax credit with the U. S. tax on the foreign source income which generated such foreign tax credit.

Explanation of S.1584

Domestic Loss Recapture Rule - Explanation and Objective

Utilizing an approach similar to that of section 904(f), the bill seeks to remedy a situation that affects U.S. companies with domestic losses, foreign income, and a foreign income tax rate close to or above the U.S. rate. In any given year there will be a number of companies facing that combination of circumstances, but the situation is especially pronounced during a domestic recession.

In the calculation of a taxpayer's worldwide income, a domestic loss serves to reduce foreign source taxable income thereby reducing or eliminating U.S. tax. In the situation where the foreign income tax rate is above the U.S. rate, foreign tax paid with respect to foreign source income will go unused, in whole or in part, depending on the extent to which the domestic loss offsets the foreign source income. When the domestic loss operation turns profitable in a subsequent year, the domestic income cannot be offset by the prior year's domestic loss because it was previously utilized in computing worldwide income. The net effect of this set of facts is that (i) the subsequent year's U.S. income will be subject to tax and (ii) the prior year's unused foreign tax credit will not be available to offset that tax because the foreign tax credit in the subsequent year will be limited to the U.S. tax on foreign source income arising in that year. For example, if over a two year period, a U.S. company incurs a domestic loss of $100 in year 1 and a domestic profit of $100 in year 2, and $100 of foreign profit and $46 of foreign income tax in each of the two years, it will pay more tax over the 2 year period than if it had no domestic income in either year (i.e., than if the domestic loss in year 1 had been available to offset the domestic profit of year 2 rather than the foreign profit of year 1.) 1/

1/

	Present Law		Proposal	
	Year 1	Year 2	Year 1	Year 2
Foreign source taxable income	100	100	100	100
Foreign tax paid	46	46	46	46
U.S. source taxable income	-100	100	-100	100
Worldwide taxable income	0	200	0	200
U.S. tax	0	92	0	92
Foreign tax credit	0	46	0	92
Excess foreign tax credit	46	0	46	0
Total U.S. tax paid	0	46	0	0
Foreign tax credit carryover	46	46	46	0

The problem described above arises because under U.S. law, the domestic loss and foreign source income in a single year are offset in calculating worldwide income and the calculation, under our annual accounting concept is made on a year-by-year basis. U.S. law currently has no mechanism for looking at two years together. The same type of problem was the subject of the enactment of section 904(f), that is, the double tax benefit afforded a taxpayer over a two-year period resulted from the absence from U.S. law of a mechanism for modifying the annual accounting concept. Mechanically, section 904(f) operates by disregarding a strict annual accounting concept and, instead, requiring foreign losses of one year to be carried over to offset foreign profits of a subsequent year. The bill would introduce such a symmetrical rule by providing for a domestic loss recapture.

Under the proposal, overall domestic losses would be reclassified as foreign source income in subsequent years when the taxpayer has domestic source income. "Overall domestic loss" is defined as the excess of the deductions apportioned or allocated to domestic income (including the section 172(a) net operating loss deduction) over domestic gross income, but only to the extent that foreign source income is offset by an overall domestic loss.

The bill requires the taxpayer to reclassify as foreign source income the lesser of the amount of the overall domestic loss (reduced by recapture of overall domestic losses in prior years) or 50 percent (or more, at the taxpayer's election) of the domestic income in such year. The effect of this provision would be to increase the foreign tax credit limitation, thus potentially increasing the amount of available foreign tax credit.

The effective date for this provision is taxable years beginning after December 31, 1981.

Extended Carryover Period for Excess Foreign Tax Credits

The bill would increase the foreign tax credit carryover period from five years to 15 years for taxable years beginning after December 31, 1981 with respect to excess foreign tax credits that arose in taxable years beginning after 1978.

First-In-First-Out Rule

The bill would change the ordering rules for utilization of foreign tax credits. It would provide a new rule under which foreign tax credits that arise currently would no longer be the first foreign tax credits used; instead, under a FIFO (first-in-first-out) rule, foreign tax credits generally would be utilized in the order in which they arose.

The FIFO ordering rule would be effective for taxable years beginning after 1981.

For the reasons I will describe, we are unable to support the bill although we think the domestic loss recapture rule has conceptual merit.

Discussion

Domestic loss recapture rule

It can be argued in support of the domestic loss recapture rule that symmetry of tax treatment between foreign and domestic losses mandates a domestic loss recapture rule similar to the section 904(f) foreign loss recapture rule. Perhaps when Congress was addressing the potential abuse relating to double benefits with respect to foreign losses, it also should have considered the possibility that the reverse situation might arise and require attention. Accordingly, the enactment of the domestic loss recapture rule may be regarded as merely remedying a deficiency in the statute, thereby eliminating potential differences in tax treatment between taxpayers with the same total income over a period of time where one has an overall domestic loss and the other does not.

Another argument in support of a domestic loss recapture rule is that the present system penalizes companies operating in high tax foreign countries compared to those operating in low tax jurisdictions. In the latter situation, the taxpayer is more likely to be able to utilize its excess taxes in a carryback or carryover year. Although we are sympathetic with these arguments and agree that, at least mechanically, the proposed domestic loss recapture provision is symmetrical with a foreign loss recapture provision contained in section 904(f), there are contrary arguments and we are concerned that implementation of the proposed rule would have a number of unintended effects.

Congress enacted the foreign loss recapture rule of section 904(f) because of the potential for a double tax benefit occurring when an overall foreign loss reduced U.S. tax but corresponding amounts of foreign income in later years were not subject to U.S. tax because of the utilization of the foreign tax credit. This discrepancy occurred principally when business activities were conducted in foreign countries that did not provide for loss carryovers. These countries imposed tax on the full amount of annual income without reduction for prior year losses. Absent a foreign law net operating loss carryover provision and the U.S. foreign loss recapture rule of section 904(f), the United States allowed a foreign tax credit for these taxes based on the full amount of foreign source income derived in the later year. The foreign loss recapture rule was intended inconsistent with U.S. tax principles. Without such a provision, the U.S. Government, in effect, was subsidizing the foreign government's failure to provide a net operating loss carryover.

It can be argued that the foreign tax credit was enacted only to prevent the double taxation of foreign source income, and that a domestic loss recapture rule should not be enacted because the present rules do not lead to the double taxation of foreign source income realized in a particular year. We recognize that a possible consequence of a domestic loss is a smaller foreign tax credit limitation (and a concomitant increase in foreign tax credit carryovers) for a taxpayer operating in a foreign country with tax rates equal to or in excess of U.S. tax rates. The excess credits arise in domestic loss years because the loss reduces worldwide taxable income before the credit computation. In fact, however, the loss may totally eliminate all U.S. tax on foreign source income. In such a case, there will be no double tax on the foreign source income. It is certainly arguable that the operation of the present statury scheme is not inequitable because the credit's only function is to preclude a double tax on foreign source income.

One can further argue that the problem is not a foreign tax credit problem at all but, rather, results from our concept of taxing worldwide income. If, instead of combining domestic and foreign source income in arriving at worldwide income, the U.S. system recognized two categories of income, namely, foreign source income against which credit could be claimed up to an amount equivalent to the U.S. tax imposed on that income (without reference to U.S. losses allocated thereto), and domestic source income on which U.S. tax would be imposed without regard to foreign source income (or losses allocated thereto), this problem would disappear. However, that "solution" would be very unpopular with taxpayers having low taxed foreign source income. Moreover, a two track system would represent a major departure from our present tax system and we do not urge it as a solution to the present problem.

In addition, we have identified several circumstances in which the proposal would have unintended, adverse effects. For example, assume in year 1 that a U.S. company incurred a $100 U.S. loss and received $200 in the form of a dividend from its DISC, which dividend is foreign source income under section 861(a)(2)(D) and which carries with it a foreign tax credit of $20, subject to the DISC separate foreign tax credit limitation of section 904(d). The taxpayer's pre-credit U.S. tax is $46. This is reduced by a $20 foreign tax credit with the result that the taxpayer pays $26 in U.S. tax. In year 2 assume the taxpayer earns $150 of U.S. income and $200 of foreign source income, not subject to a separate limitation, with respect to which it paid $140 of foreign tax. Its pre-credit U.S. tax is $161. This tax is reduced by a $92 foreign tax credit, with the result that the taxpayer pays $69 in U.S. tax and has a $48 foreign tax credit carryover. (This excess tax can not be carried back to year 1 because the excess limitation in year 1 is in a separate limitation basket.) For the two years, the taxpayer pays a U.S. tax of $95 and has a $48 foreign tax credit carryover.

Assuming the same facts, under the proposal the taxpayer pays the same U.S. tax in year 1 ($26). However, in year 2, in computing the taxpayer's foreign tax credit, because of the recharacterization of $100 of U.S. source income as foreign source income, the taxpayer would receive a $138 foreign tax credit--so the taxpayer would pay $23 of U.S. tax with a $2 carryover--with the consequence that for the two years the taxpayer would pay only $49 of U.S. tax with a $2 foreign tax credit carryover. The foregoing result should be contrasted with the situation where years 1 and 2 are collapsed so that the domestic loss offsets only domestic source income, the presumed intention of the proposal. In that situation the taxpayer has $50 of U.S. income, $200 of foreign source DISC dividend income, and $200 of other foreign source income. Its U.S. pre-credit tax is $207 which is reduced by a $112 foreign tax credit--so the taxpayer pays $95 of U.S. tax and has a $48 foreign tax credit carryover. Thus, under either current law or by a collapse of the two years, the taxpayer in this situation is not affected by the domestic loss--in either case it pays $95 of U.S. tax. However, under the bill as drafted this taxpayer would pay only $49 of U.S. tax.

We also are concerned that the proposal may increase pressure on the pricing and allocation rules. Overallocating expenses or underallocating income to domestic source income might be beneficial even if the allocation produces a domestic loss. Under present law there is an incentive to maximize the foreign tax credit limitation by allocating expenses to domestic rather than foreign source income thereby increasing the percentage of worldwide income allocable to foreign sources. However, a taxpayer would resist such an allocation if, as a result, it created a domestic loss since the loss would then begin to offset foreign source income, thereby potentially reducing the foreign tax credit limitation. Under the proposal, since a domestic loss would be subject to recapture in future years, the incentive to overallocate expenses to domestic sourse income would be even greater since any loss created by the overallocation would not result in a loss of any foreign tax credits.

In addition, the bill does not contain any restriction on the use by an acquiring company of an acquired company's domestic loss recapture benefits. Such benefits clearly would be parallel to net operating losses and excess foreign tax credits and other tax attributes of acquired companies the transfer of which are restricted by the Code and regulations. Similar provisions should apply to domestic loss recapture benefits.

We also object to the proposal's retroactive effective date. By being effective for taxable years beginning after 1981 the proposal may be retroactive in two respects. First, it permits overall foreign losses incurred in tax years beginning after December 31, 1981 to be recharacterized. In addition, it may allow for the reopening of returns for taxable years beginning after December 31, 1981 in order to recharacterize domestic income in that year because of pre-1982 overall domestic losses. We are opposed to both forms of retroactivity. Absent extraordinary circumstances warranting such treatment, the Treasury Department opposes retroactive legislation.

Finally, and most importantly, we oppose the provision because our preliminary analysis indicates that a large volume of losses and excess credits may be utilized as a result of the proposed legislation. As a consequence, the potential revenue cost may be very substantial. The revenue cost occurs as a taxpayer's domestic loss operations become profitable and, therefore, it would be spread over several years. As a result of the strength of the current economic recovery, a substantial revenue drain is likely to occur in fiscal year 1984, although the most significant revenue cost would be for fiscal years 1986-88. In the current budgetary situation we simply cannot support a proposal with a potentially substantial revenue loss.

In summary, although we are not unsympathetic to the economic consequences resulting from the absence of a domestic loss recapture provision, we cannot support this proposal. Although we recognize that the foreign loss recapture rule applies on a transactional basis, and that absent a domestic loss recapture rule, there is a lack of symmetry with respect to domestic losses, many of the problems associated with the absence of a domestic loss recapture provision result from the methodology applied in computing and applying our foreign tax credit limitation and perhaps is better dealt with in connection with a comprehensive review of the foreign tax credit provisions. In addition, introduction of a domestic loss recapture provision may lead to unintended consequences and certainly would produce a substantial revenue loss.

Extended Carryover Period for Certain Excess Foreign Tax Credits

Proponents of the extension of the foreign tax credit carryover period from five years to 15 years argue that the carryover period should conform to the investment tax credit carryover period. (The same argument is made with respect to the proposed FIFO ordering rule.) Under this argument, it is pointed out that the investment tax credit and the foreign tax credit both originally had five year carryovers, but whereas the investment tax credit has been "modernized", the foreign tax credit has not. Proponents note that the present 15-year carryover period for the investment tax credit (and the FIFO ordering rule) are the result of a series of amendments, primarily in 1976 and 1981, which reflect the growing recognition by Congress that net operating losses may cause investment tax credits and foreign tax credits to expire unused. We do not agree with this analysis.

Congress enacted the foreign tax credit carryback and carryover provision for a specific purpose, namely, to prevent double taxation caused by different methods of reporting income in the United States and other countries. As discussed earlier, the Ways & Means Committee was concerned that distortions could result from income being reported in different years in the United States and a foreign country. In fact, the Senate Finance Committee, while recognizing that "there is the problem of the difference in the time of reporting income", nonetheless omitted the carryback and carryover provision from its draft of the Technical Amendment Act of 1958 because of the Committee's concern that "the effect of the foreign tax credit carryover of the House bill is not limited to cases where there is a difference in the time of reporting income. . . ." See S. Rep. No. 1983, 85th Cong., 2d Sess. 117-18 (1955). Interestingly, the Senate Report specifically expressed concern that the carryover would be available where the taxpayer has U.S. losses even though there are no variations in the time of reporting income.

The purposes for the carryover and carryback of investment tax credits and the net operating losses are very different. The net operating loss carryover and carryback periods are intended to allow taxpayers to average income and loss over a number of years. The investment tax credit carryover functions to preserve the domestic investment incentive that the investment tax credit was enacted to provide.

The limited foreign tax credit carryover and carryback can be viewed as necessary to preserve the matching concept which is the basis of our foreign tax credit system. Under the principles of "matching", a foreign tax credit is allowed for foreign income taxes paid on certain income in order to avoid double taxation. By extending the carryover, it is arguable that we would no longer be adjusting for mere timing or base computation differences resulting from differing foreign tax treatment, but instead would be permitting the foreign tax paid on one year's income to offset U.S. tax on another year's foreign source income.

Even accepting the original purpose for the foreign tax credit carryover, there is no necessary magic to the five year period, and we are not unreceptive to the idea of extending the carryover period. However, our data do not permit determining how long a period is needed to achieve the purpose of the carryover in reconciling differences between tax systems in reporting income and deductions. There appears to be no reason to conform the carryover period with that of the investment tax credit and net operating loss given the completely different function of the foreign tax credit carryover. However, if the Subcommittee concludes that, based on the principles underlying the carryover, a five year period no longer operates to adjust adequately for differences in foreign tax treatment, we would be pleased to work with you in seeking to identify an appropriate carryover period.

First-In-First-Out Ordering Rule

The primary argument for adopting the FIFO ordering rule for the utilization of foreign tax credits is to conform such foreign tax credit ordering rules with the investment tax credit ordering rules. As with the investment tax credit carryover provision, the FIFO ordering rule was adopted in the investment tax credit area for a specific purpose which does not apply in the case of the foreign tax credit. Enactment of a FIFO investment tax credit ordering rule reflected Congressional concern that taxpayers with large investment credit carryovers would not be able to use these credits because of low levels of taxable income, net operating losses, or future credits. Moreover, Congress feared that "the desire of taxpayers to use investment credit carryovers as quickly as possible could significantly dampen the stimulative effect of the investment credit on new investments. . . ." General Explanation of the Tax Reform Act of 1976, 94th Cong., 1st Sess. 165 (1976). As a result, the ordering rule was changed to better facilitate the use of carryover credits.

The use of a FIFO rule in connection with the foreign tax credit is inconsistent with the matching principle. As stated previously, the "matching" principle provides that a foreign tax credit should be allowed for foreign income taxes paid on certain income. Under a FIFO rule, foreign taxes paid in a previous year would be credited against U.S. tax on later-year income before the foreign taxes actually paid on the later-year income is credited. This approach would not be consistent with the premise of matching foreign tax credits to income subject to income taxation. Accordingly, we oppose the adoption of this provision.

S. 1814

Amortization of Bus-Operating Rights

Background

On November 19, 1982, the Bus Regulatory Reform Act of 1982 was signed into law to reduce regulation of the intercity bus industry. The Bus Act makes it easier for intercity bus operators to obtain route operating authorities from the Interstate Commerce Commission, although entry restrictions still remain. These restrictions continue to protect existing businesses from competition. As a result of this easing of regulation, however, the value of previously granted bus-operating authorities has declined.

Under section 165(a) of the Code, a deduction is allowed for any loss incurred in a trade or business which is evidenced during the taxable year by a closed and completed transaction and fixed by an identifiable event. The amount of any deduction allowed may not exceed the adjusted basis of the property involved. No deduction is allowed, however, for a mere decline in value of property. These rules have been applied by the courts to deny deductions for the diminution in value of an operating permit or license in circumstances closely comparable to those presented by the reduced regulation of the intercity bus industry.

When the interstate motor carrier industry was deregulated, Congress enacted a special relief provision to allow taxpayers who at that time held motor carrier operating rights to deduct the adjusted basis of these rights ratably over a period of 60 months. Congress concluded that the unique circumstances of the deregulation of the trucking industry made necessary some form of relief that was not available under existing law.

Description of S. 1814

Under S. 1814, a deduction would be allowed ratably over a 60-month period for taxpayers who held one or more bus-operating authorities on November 19, 1982. The amount of the deduction would be the aggregate adjusted basis of all bus-operating authorities that were held by the taxpayer on that date or acquired thereafter under a contract that was binding on that date. The bill also provides authority for the Treasury Department to prescribe regulations under which, for purposes of this amortization deduction, a taxpayer who owns stock in a corporation holding eligible bus-operating authorities would be able to elect to allocate to the authorities an allocable portion of the taxpayer's basis in the corporation's stock in certain situations where a controlling stock interest in the corporation was purchased within a 12-month period. This election would be available only if the stock was acquired on or before November 19, 1982, or pursuant to a binding contract in effect on such date. The bill also would allow unused bus-operating authority amortization deductions to carryover to successor corporations in certain transactions.

S. 1814 would be effective for taxable years ending after November 18, 1982.

Discussion

S. 1814 is patterned after section 266 of the Economic Recovery Tax Act of 1981, which allowed taxpayers who held operating authorities as motor carriers of property to amortize the adjusted basis of these operating authorities over a 60-month period. We opposed the enactment of section 266 on the basis that even though the deregulation of the trucking industry caused a decline in the value of the operating rights, those rights continued to have value since the ICC continued to require a taxpayer to secure such rights in order to conduct a trucking business. We also pointed out that if it was decided to give special tax relief to affected motor carrier operators, the proper amount of the loss deduction should be the taxpayer's basis in the operating rights reduced by the post-deregulation value of these rights, not the full amount of the taxpayer's basis in the operating rights.

I would like to emphasize that the deregulation of motor carriers is no different from any other deregulation that causes a diminution in value of a license or operating right. Other industries, most notably the airline industry, have been deregulated without the grant of any special tax relief for this reduction in value.

Moreover, our tax system taxes gains and permits a deduction for losses only when those gains or losses are recognized by an identifiable event; in the case of gains or losses attributable to property, this typically occurs upon the sale or exchange of the property. Permitting a current deduction for a decline in the value of assets prior to disposition while not taxing unrealized gains is contrary to our present system of taxation and sets an unfortunate precedent. While we acknowledge that no distinction can be made between the deregulation of motor carrier operators and intercity bus operators, if S. 1814 is enacted the door will be open for all other deregulated industries to seek similar relief. Therefore, we must oppose S. 1814 on the same basis that we opposed section 266 of the Economic Recovery Tax Act of 1981.

S. 1815

Exemption from Tax for Certain Collective Real Estate Investment Corporations

Background

The Internal Revenue Code provides an exemption from income tax for a variety of nonprofit entities ("exempt organizations"). Section 501(c)(2) of the Code exempts from tax so-called "title-holding companies". A title-holding company is a corporation organized for the exclusive purpose of holding title to property, collecting the income therefrom, and turning over the entire income (less expenses) to another exempt organization. The literal language of section 501(c)(2) requires that an exempt title-holding company turn over the income collected to "an organization". The question has arisen whether the statute permits an exempt title-holding company to have more than one parent. Another unresolved issue is whether a title-holding company which turns over all of its income to one or more exempt organizations may be exempt under section 501(c)(2) when it is organized by a for-profit company, such as an investment adviser or brokerage company.

Another provision of the Code, section 501(f), specifically exempts from tax certain collective investment activities undertaken by exempt educational organizations. Section 501(f) provides that an organization which is organized and operated solely to hold, commingle and invest in stocks and securities (including engaging and supervising independent contractors to provide investment services) is considered to be organized for a tax-exempt charitable purpose. Section 501(f) further requires that the organization's members consist exclusively of exempt educational organizations (or related publicly supported investment funds of State universities), and that the organization be organized and controlled by one or more of its members.

Although exempt organizations generally are exempt from tax, section 511 of the Code imposes a tax on income earned by an exempt organization from the conduct of an unrelated trade or business. Unrelated business income generally is taxed at corporate rates (or, in the case of a charitable trust, at individual rates) in a manner comparable to the taxation of commercial businesses. Rents from real property (and other types of passive income) generally are excluded from the unrelated business income tax unless the acquisition of the property producing the income is debt-financed.

In general, the rules relating to debt-financed property provide that a share of any income from debt-financed property, proportional to the ratio of debt on the property to the adjusted basis of the property, is treated as income from an unrelated trade or business. An exception to the debt-financed property rules provides that income from debt-financed real estate investments of qualified pension trusts are not subject to tax, provided certain conditions are satisfied.

The debt-financed property rules are intended to prevent the use of an exempt organization's tax exemption for the benefit of taxable persons. The original rules relating to debt-financed property were enacted in 1950 in response to abusive sale-leaseback transactions between tax-exempt organizations and taxable owners of active businesses. These transactions typically involved a tax-exempt organization's purchase of an active business, financed primarily by a contingent, nonrecourse note, followed by a lease of the assets of the business to the seller. The effect of these transactions was to convert the ordinary income of the business into capital gains for the seller while allowing the tax-exempt organization eventually to acquire property with little or no investment of its own funds. The primary objection to sale-leaseback arrangements involving borrowed funds was that they permitted an organization's tax exemption to benefit the taxable seller, either by conversion of ordinary income into capital gain income or by payment of a higher price for the property than a taxable purchaser would pay.

Description of S. 1815

S. 1815 would add to the Code a new section 501(c)(24), which would exempt from tax a corporation organized exclusively for the purpose of acquiring and holding title to property, collecting income from the property, and paying the income (less expenses) to one or more qualifying exempt organizations. Qualifying organizations would be: (1) qualified pension, profit sharing, or stock bonus plans which meet the requirements of section 401(a); (2) governmental plans as defined in section 414(d); (3) the United States, any State or locality, or any Federal, State or local agency; and (4) organizations described in section 501(c)(3). Under the bill, a corporation could be exempt from tax even if it was organized and controlled by profit-making entities.

The bill also would extend to organizations exempt under section 501(c)(24) the exception to the debt-financed property rules which currently applies to certain real estate investments made by qualified pension trusts. The bill would be effective for taxable years beginning after December 31, 1983.

For convenience, I will refer to organizations which would be exempt from tax under the bill as collective real estate investment corporations.

Discussion

The Treasury Department opposes S. 1815 as drafted. We believe that exempt status for collective investments by exempt organizations should be limited to entities that are organized and controlled by exempt organizations. In addition, we oppose expansion of the existing exception to the debt-financed property rules which is currently applicable only to qualified pension trusts.

Collective Investments

Treasury has no objection to permitting tax-exempt organizations to make collective investments through the use of a corporation. It would be very undesirable, however, if the use of the corporate collective investment vehicle resulted in a transfer of control over basic investment decisions from the tax-exempt investors to for-profit entities. For example, we are concerned that if a for-profit investment adviser organized a collective investment corporation and the investment adviser had significant representation on the board of directors of the investment corporation, the investment adviser effectively would control the investment decisions of the tax-exempt organizations which invest in the corporation. Exempt organizations would have little recourse if they became dissatisfied with the operation of an investment corporation that is controlled by private interests.

Limiting tax-exempt status for collective real estate investment corporations to organizations which are organized and controlled by exempt organizations should ensure that such corporations are operated in a manner that is consistent with the investment objectives of the investing exempt organizations. The investing exempt organizations would be free to retain the investment adviser of their choice and to replace unsatisfactory advisers.

Section 501(f), the closest analogue to proposed section 501(c)(24), provides that tax-exempt cooperative investment funds of educational organizations must be organized and controlled by one or more investing exempt organizations. The legislative history of that section expressly provides that, if a private brokerage company or investment adviser initiated the formation of a cooperative investment organization in order to obtain customers for its business, such an organization would not be exempt under section 501(f). We believe that similar limitations should be placed on collective real estate investment corporations. This should not preclude investment advisers from being instrumental, in an advisory capacity, in the formation of collective real estate investment funds for exempt organizations.

Further, we think that the question of tax-exempt status for collective investment funds of exempt organizations deserves a more comprehensive review. Tax exemption under section 501(f) is limited to collective securities investment funds that are organized and controlled by educational organizations. S. 1815 would limit tax-exempt status to collective real estate investments for a different, but also limited, group of exempt organizations. We see no policy reason for granting tax exemption to collective investments in such a piecemeal fashion. If collective investment funds for exempt organizations are to be accorded tax-exempt status, we believe that this objective should be accomplished through one comprehensive provision.

Debt-financed Property Rules

S. 1815 would extend to collective real estate investment corporations the provision that generally exempts certain real estate investments of qualified trusts from the debt-financed property rules. Treasury believes that the debt-financed property rules are sound and should not be narrowed. We do not think that the exception for qualified pension trusts is a desirable provision, and we generally oppose expansion of that exception.

By extending the exception to tax-exempt collective real estate investment corporations, the bill indirectly would extend the exception to all organizations eligible to receive payments from such corporations. On August 3, 1983, we testified before this Subcommittee in opposition to S. 1183, a bill which would extend to educational institutions the exception from the debt-financed property rules which now applies only to qualified pension trusts. We continue to oppose expansion of this provision.

As we stated in our prior testimony, we believe that the exception to the debt-financed rules permits the conversion of ordinary income to capital gain income in the hands of the seller, or the payment of an inflated price for the property based on the exempt organization's ability to receive rental income from the property tax-free. For example, nonrecourse financing by a seller of property to a collective real estate investment corporation would be permitted in many cases. In addition, an exception from the debt-financed property rules for collective real estate investment corporations would create incentives for the development of methods for transferring to taxable persons the substantial tax benefits arising from leveraged real estate investments by tax-exempt organizations. A collective real estate investment corporation might be able to enter into partnership agreements with taxable entities, which would allocate tax benefits to the taxable partners.

We are opposed to further exceptions to the debt-financed property rules. In enacting the special exception for pension trusts, Congress indicated that pension trusts were distinguishable from other tax-exempt organizations because the purpose of the exemption for pension trusts was to permit the accumulation of investment income and because the assets of pension trusts are ultimately paid to taxable individuals. In view of these distinguishing characteristics, Congress considered it appropriate to provide a special rule for pension trusts alone. While the distinctions drawn between pension trusts and other tax-exempt organizations may be tenuous, we do not believe that the existence of a special exception for pension trusts justifies further erosion of the debt-financed property rules.

For these reasons, we generally oppose an exception to the debt-financed rules for collective real estate investment corporations. Nevertheless, where a qualified trust would be exempt from the debt-financed rules if it made an investment directly, we see no policy reason for reaching a different result where the investment is made by a collective real estate investment corporation and all income is paid to one or more qualified trusts. Accordingly, we would not oppose expanding the exception to collective real estate investment corporations which make payments only to one or more qualified pension trusts.

In summary, we cannot support S. 1815 because it lacks limitations which we consider essential and because we believe expansion of the exception to the debt-financed property rules beyond qualified pension trusts is undesirable. We would be happy to work with the members of the Subcommittee to develop a comprehensive legislative solution to questions regarding the tax treatment of collective investments by exempt organization. We also will continue to work with the IRS at the administrative level to resolve issues concerning the scope of section 501(c)(2).

S. 1826

Hunger Relief Incentives Act of 1983

Background

Under current law a corporation generally can deduct the amount of cash and the fair market value of other property contributed to qualified charitable organizations. Limitations are imposed, however, with respect to contributions of property which, if sold, would yield ordinary income instead of capital gain. In the case of contributions of ordinary income property, inventory for example, the deduction is limited to the taxpayer's adjusted basis in the property which is usually the amount it cost the taxpayer to manufacture or acquire the property in question. Similarly, the deduction for services contributed to charity is limited to the donor's out-of-pocket cost of performing the services.

There are two exceptions to the general rule applicable to gifts of ordinary income property. The first exception involves corporate gifts of scientific equipment and apparatus to colleges and universities for research and research training; it is not considered further in this testimony. The second exception, which this bill would expand, applies to gifts by corporations (other than S corporations) of inventory, depreciable personal property and business real property to be used for the care of the ill, the needy or infants.

When the second exception applies, the allowable deduction is equal to the donor's basis in the property plus one-half of the excess of the value of the property over its basis (the unrealized appreciation), not to exceed twice the taxpayer's basis in the property contributed. However, even where this exception applies, if the donated property is property which has been the subject of depreciation or depletion allowances, no deduction is allowed for any amount which would be recaptured as ordinary income if the property were sold.

To qualify for this second exception under current law, the donee must be a public charity which is exempt from tax under 501(c)(3) other than a private foundation which is not an operating foundation; the use of the property must be related to the purpose or function constituting the basis for the donee's exemption under section 501 and the use of the property must be solely for the care of the ill, the needy or infants. In addition, the donee is prohibited from transferring the property in exchange for money, other property, or services. The regulations interpret this last requirement somewhat liberally and permit a donee organization to charge a fee to another organization in connection with its transfer of the donated property, if the fee (i) is small or nominal in relation to the value of the transferred property, (ii) is not determined by this value and (iii) is designed to reimburse the donee-organization for its administrative, warehousing or other similar costs.

Description of S. 1826

S. 1826 would expand the current exceptions to the ordinary income property rule in a number of ways:

(1) The bill would include the Federal government and state and local governments as qualified donees.

(2) In the case of contributions of food, donors other than corporations would qualify for the increased deduction, provided such taxpayers are actively engaged in the trade or business of the production or the wholesale or retail marketing of food. Where such taxpayers are not required to and do not use inventories to compute taxable income (as would be the case with most noncorporate farmers) the amount of the deduction would be equal to 50 percent of the gross receipts the taxpayer would have realized if the food had been sold in the ordinary course of the taxpayer's business. Moreover, the term "charitable contributions of food" would be defined to include individual contributions of food which the donee removes from the grower's fields, provided the gift would otherwise qualify for the increased deduction.

(3) The bill would permit the donee to charge a fee to the ill or needy individuals or infants who receive the property, if the fee is small or nominal in relation to the value of the transferred property and is not determined by its value, and the fee is designed to reimburse the donee for its administrative, warehousing, or similar costs.

(4) S. 1826 would provide an increased deduction for the cost of transporting the donated food to the donee organization. The increased deduction would be available either to the donor or to another taxpayer who transports the food, providing the other taxpayer is actively engaged in the business of providing such transportation services. The deduction for such services would be equal to the least of (1) the fair market value of the services contributed, (2) twice the incremental direct costs incurred by the taxpayer in providing the services, or (3) such direct costs added to one-half the amount of gain the taxpayer would have realized if the services contributed had been provided by the taxpayer at their fair market value.

Discussion

The Treasury Department opposes S. 1826. The bill would allocate additional resources to a particular form of public assistance at a time of general fiscal restraint, without a formal determination of whether this form of public assistance is preferable to other worthy programs that cannot be funded.

Making food and medical supplies available to the needy obviously is desirable. We believe, however, that the relative desirability and effectiveness of the proposal should be judged in the same manner as a direct appropriation for such a program. Thus, we respectfully submit that those members of Congress and the administration who are responsible for overseeing the entire public assistance area, not Treasury officials and the members of the tax writing committees, are the most competent persons to decide whether this proposal is the most efficient way to expand existing programs for the distribution of food and medical supplies to the needy.

Moreover, we believe there are sound tax policy reasons underlying the general rule that the deduction for gifts of ordinary income property and services should be limited to the donor's basis in the property or the cost of performing the service. This general rule produces the same tax benefit to the donor as if he sold the property or performed the service for full value and contributed the proceeds to charity. It ensures that the gift derives from charitable impulses because the taxpayer will bear a significant portion of the cost of making the gift. Absent this rule, most or all of the cost of making a gift would be borne directly by the Federal government and indirectly by other taxpayers.

In this regard, we would note two troublesome aspects to the special provision contained in S. 1826 relating to the deduction that would be permitted to cash basis donors who are not required to maintain inventories. First, permitting these taxpayers to deduct 50 percent of the gross receipts that would have been realized from the sale of contributed property affords them a more generous deduction than taxpayers who are required to maintain inventories. The latter are permitted to deduct their cost of producing contributed property, plus one-half of their unrealized appreciation in the property, subject to the two times basis limitation. By contrast, cash basis taxpayers will have already deducted their costs of producing any contributed property as such costs are incurred. To permit them to deduct one-half of the gross receipts from a hypothetical sale of the property permits a deduction unrelated to the unrealized appreciation in the property. For example, assume that it costs Jones $1,200 to produce a particular food product which he can sell for $2,000. He chooses to contribute the product to a qualified charity. If Jones were an accrual method taxpayer who is required to maintain inventories, he would be permitted to deduct $1,600, his production costs of $1,200 plus one-half of his unrealized profit or $400. If Jones were a cash method taxpayer who is not required to maintain inventories, his production and donation of the food would permit him a total deduction of $2,200; that is, he would be permitted under the cash method of accounting to deduct his production costs of $1,200, and he would be allowed a charitable contribution deduction of one-half of his potential gross receipts, or $1,000.

In addition, we foresee serious difficulties in administering a deduction measured by gross receipts realized from a hypothetical sale of food products. This measurement problem exists to a limited extent today, but it would be magnified significantly under S. 1826.

Finally, we have particular problems with that aspect of S. 1826 which would permit an increased deduction for contributions of transportation services in connection with contributions of food. At present, there is no exception to the general rule that the deduction for gifts of services is limited to the direct cost of performing the services. A Gallop Survey conducted in 1980 reported that individuals contribute about 8.4 billion hours of volunteer services to charity annually. To fashion a special rule for transportation services will undoubtedly open the door for similar treatment with respect to the donation of other services.

For these reasons, we oppose S. 1826.

This concludes my prepared remarks. I would be happy to answer your questions.

Senator PACKWOOD. I have questions, Mr. Secretary, on only two bills.

On S. 1814, you oppose the bill even though it is almost identical in form to the rights we extended to the truckers when we deregulated. You say one of the reasons that you were opposed to even that bill was because the operating rights continued to have value since the ICC continued to require a taxpayer to secure such rights in order to conduct a trucking business. That is true in theory. Entry has become so easy, however, the rights are almost de minimus in terms of value.

Mr. PEARLMAN. Yes. I think our problem, Mr. Chairman, is that we think those rights nevertheless have value.

Senator PACKWOOD. Well, let me ask you this:

If you think they have value, then you apparently indicate in the next sentence that you have no objection to the bill if the depreciation would be the basis less whatever value there is?

Mr. PEARLMAN. No, I think our objection is broader than that. I think we have a broad-based concern with diminution in value being a deduction triggering event. The losses in question should not be deductible any more than the reduction in the value of a piece of real estate or the reduction in value of a share of stock. We think the valuation problems that will inevitably arise are such that it's better policy to establish that the time at which a taxpayer recognizes either income or loss is when the taxpayer disposes of property. And we think the rule should be no different in the case of a right which by reason of deregulation has diminished in value, even if it has diminished substantially in value.

Senator PACKWOOD. So you say that rather than depreciating it you are going to take whatever loss there is at the time of disposal. If it has no value at all, do you take the full loss at that time, then?

Mr. PEARLMAN. That is correct.

Senator PACKWOOD. So you can just give it away tomorrow, because you can't sell it to anybody, and take the full loss?

Mr. PEARLMAN. Well, in the event the taxpayer is able to determine that the——

Senator PACKWOOD. That's better than amortizing it, would be my guess, from the standpoint of the company. If it has no value and they can give it away and take the full deduction, my hunch is—they are going to testify a little later—my hunch is they would prefer that.

Mr. PEARLMAN. Well, I think under current law if a taxpayer owned an operating right and disposed of it by a sale for a dollar, that would be an appropriate recognition event. I don't think any change in the law is needed for that purpose.

But I think we want to get away from the idea of getting into fights with taxpayers about whether in fact value has gone down prior to the time the asset has been disposed of.

Senator PACKWOOD. Yes. I can assure you that in trucking the operating rights have almost no value, and we effectively took care of that when we made almost unlimited entry into the trucking business.

But I just wanted to make sure I understand your position. If that is true, assuming an operating right that once had $100,000 value now has a $1,000 value, you are saying that the $99,000 loss could be taken in the tax year that you received the $1,000 for the sale of the operating rights?

Mr. PEARLMAN. I think that is correct, under current law. Right.

Senator PACKWOOD. Now let me ask you a question on S. 1815. You make this statement:

> We are concerned that if a for-profit investment advisor organized a collective investment corporation, and the investment advisor had significant representation on the board of directors of the investment corporation, the investment advisor effectively would control the investment decisions of the tax-exempt organization which invest in the corporation.

So what?

Mr. PEARLMAN. Well, we don't think that for-profit organizations which could have motives that are not purely altruistic should be put in a position of controlling actually or effectively the exempt organizations. For example, we don't think a real estate broker who could well have effective control of a collective investment organization should be in a position to assure his ability to gain the benefit of any real estate commissions on purchases or sales of property from that organization.

Senator PACKWOOD. What you are saying is, they might manipulate the tax-exempt corporation for a secondary or tertiary benefit?

Mr. PEARLMAN. That's correct. Well, at least we are concerned about that. Obviously we can't say that that is going to happen in every case, because it will not; but that is what we are concerned about. I think that is what Congress was concerned about in its prior legislative activity in this area, and we think prudence would suggest that if control of the organization is left with the extempt organization, the likelihood of that happening is very much diminished.

Senator PACKWOOD. Senator Danforth.

Senator DANFORTH. Let me ask you first about S. 1584. It's my understanding that under the present law the carryforward feature of unused foreign tax credits is very seldom available. Is that correct?

Mr. PEARLMAN. Well, I guess I would answer you this way, Senator: There are companies with substantial excess foreign tax credits which will undoubtedly expire. I am simply not in a position to say that they are very frequently not utilized, but obviously there are companies with large excess foreign tax credits that will not be able to be used during a 5-year period.

Senator DANFORTH. Could you explain why they couldn't use it, even though there is a carryforward?

Mr. PEARLMAN. Well, it could be, for one of a couple of reasons. Obviously, to the extent that those businesses might suffer domestic losses on a long-term basis, then those domestic losses would continue to offset foreign income and thereby cut down the worldwide taxable income calculation.

But the other reason, even if there is domestic income, is that to the extent a business operates abroad in a country which taxes at an effective rate at or near our rate, 46 percent or thereabout, then it simply will not generate sufficient foreign source income in any particular year that exceeds the foreign tax credit that is generated in that particular year.

So again, if I can just go back to my example, in year two I posited a situation where we had $200 of income—$100 that was foreign source, $100 that was domestic—and there was plenty of foreign tax credit to offset the entire tax liability. Because the statute operates to limit the foreign tax credit to the foreign source taxable income, or to be more precise, to that portion that the foreign source taxable income bears to the total taxable income of the taxpayer, it effectively forces you, if your foreign effective tax rate is equal to or near the U.S. tax rate, to using only the foreign tax credit generated in the year that foreign taxable income is generated.

Now, if it's a company that is in a low foreign tax rate jurisdiction, so that it might generate foreign source income at a low foreign effective tax rate, then that income would be available to offset prior years' credits. I think that's two basic reasons.

Senator DANFORTH. It is common—isn't it?—that a company which does have foreign income and foreign taxes, and that cannot utilize the foreign tax credit in the year in which the taxes are incurred, as a practical matter isn't able to use the carry forward?

Mr. PEARLMAN. I think it is certainly common. Yes, I would say that's common, particularly for companies operating in the more industrialized countries where the rates are either equal to or higher than the U.S. rates. I think that's an accurate statement.

Senator DANFORTH. And, further, that the purpose of Congress in having the carryforward is thwarted—isn't it?—by not having available a carryforward which is operable?

Mr. PEARLMAN. Well, I'm not going to say that's wrong, but that's where I think it is necessary to consider what was the original purpose of the credit and the carryforward.

Look back to the legislative history. Congress said the credit was designed to preclude a double tax on foreign source income. And at least in the domestic loss situation, where you have a domestic loss that eats substantially into the foreign income or totally offsets the foreign income, certainly one cannot argue that that foreign income has been subjected to a double tax; it was taxed abroad, but it certainly was not taxed in the United States.

But the other legislative history question has to do with the whole purpose of why there is a foreign tax carryover at all and it was not, as we best understand it from the legislative history, to assure that foreign tax credits ultimately will be utilized, but rather was enacted in recognition of the fact that because of differences in foreign laws and domestic laws, an item of income or deduction might be taxable in the United States at a different time than it is taxable or deductible in a foreign country. An example is an item of income that might, in the United States, be eligible for deferral under the installment sale method, but might be currently taxable in a foreign jurisdiction. So, Congress provided a foreign tax credit carryforward in order to make sure that when that income ends up being taxable in the United States in a subsequent year, the foreign tax credit is available.

But, Senator, I think it is rather clear that the carryover provision was not designed simply to make sure that ultimately foreign tax credits were available for use.

This is not to mean, however, as I indicated or tried to indicate in my comments, that there is any particular magic to a 5-year period. It may well be that you can look to the original objective of the carryforward provisions and conclude that 5 years is not long enough. And if the subcommittee determines that that is the case, that to pick up the timing differences that occur between U.S. laws and foreign laws that 5 years is not long enough, under those circumstances we do not think an extension of the carryforward would be inappropriate. Although we don't think there is any automatic reason to say 15 years is the right period of time, we are not so wise as to suggest some other period as being a better period.

Senator **DANFORTH**. You might have other examples, but to my knowledge the industry that would be most affected by S. 1584 is the steel industry.

Mr. **PEARLMAN**. Well, I really can't say yes to that. But as best we can tell, it is the capital-intensive heavy industries of the United States, which certainly includes the steel industry, which have suffered rather substantial domestic losses over the past several years. I think that's correct, yes.

Senator **DANFORTH**. Major industries in increasingly difficult competitive positions with respect to international trade have very difficult times here at home, but they have been able to make some sales abroad.

Mr. **PEARLMAN**. Yes, I think that's an accurate statement.

Senator **DANFORTH**. Wouldn't that be something that we should encourage?

Mr. **PEARLMAN**. Well, if it weren't for the revenue impact that we are very much concerned with, I think we probably would be sitting here saying,"Yes, we think it is something that should be encouraged." But our best judgment suggests that the revenue impact is very substantial, and that obviously is of great concern to us.

Senator **DANFORTH**. Well, that is something obviously that the administration and the Congress would have to weigh: What is the revenue impact? But I think it is important to recognize that what we are dealing with here is the steel industry and perhaps other heavy industries that are having very difficult times here at home, that are making profits perhaps in other countries. And the question is: Do we want them to be able to utilize the foreign tax credit, which because of their domestic losses are not usable?

If we had a profitable industry here at home, which was equally profitable in Europe, that industry would be able to utilize the foreign tax credits.

Mr. **PEARLMAN**. Yes, that's right.

Senator **DANFORTH**. But if it is a company that is making money in, say, Europe, and losing a lot of money here at home, and losing money year after year here at home, we would say, "Well, the foreign tax credit that the profitable company could utilize cannot be utilized by the losers."

Mr. **PEARLMAN**. I think that's a correct statement, Senator.

Let me point out that the bill only becomes operational, if you will, in a particular company's cycle once it starts becoming profitable in the United States. So I would suggest to you that if it's looked at as an incentive or a benefit for companies that are in long-term loss positions and a way to get some benefit to those companies, I would simply note to you that it will not operate at that point. The benefit only comes when that company turns around its domestic operations and does begin earning income in the United States.

Senator **Danforth**. OK.

Mr. **Pearlman**. But I think we are sympathetic, certainly, to the concern that the bill is trying to address, and we tried to indicate that in our statement.

Senator **Danforth**. On the question of S. 1826, has the position which you have stated on behalf of the Treasury Department been reviewed by the administration as a whole? Or is this simply the Treasury's position?

Mr. **Pearlman**. Well, our testimony has been reviewed through our normal review processes by the Office of Management and Budget, which is the vehicle that is used in the administration for reviewing testimony. So this stands as the administration's position.

The extent to which Health and Human Services, for example, was involved in that review, I simply cannot tell you.

Senator **Danforth**. And the White House, other than OMB?

Mr. **Pearlman**. Well, to the extent there was coordination between OMB and the White House, I am simply not privy to that. I just don't know.

Senator **Danforth**. The reason I asked that is that I have the distinct impression, based upon discussions with people in the White House, that the problem of hunger is something that is on their minds, and that the idea is to try to relieve hunger both here and abroad, and to to so in a way which does not necessarily make the Federal Government the administrator of all hunger-relief programs; that is to say, my impression has been that the idea of the administration has been to encourage the private sector to play the leading role in hunger relief, and the idea of a second harvest operation or getting farmers to contribute food for the purpose of feeding people has been something that the administration has taken an interest in.

With respect to the transportation portion of the bill, when I made a tour of food providers in my State earlier this year, almost every one of them told me that one of the problems is transportation. They can have food available, but transporting it is quite a different matter—even the Government commodities giveaway programs, the cheese distribution and so on, they are saying, "Well, to have the food available is one thing, but how do we get it from point A to point B."

So the purpose of this bill is to both encourage producers of food to give their food away, and to encourage providers of transportation to do that.

I suppose that the Government could get into the business of everything. I mean, it could by direct grant buy foods. Lord knows, it buys a lot of food as it is. And then it could buy trucks and it could hire Government employees, and have the Government employees drive trucks from one place to another and deliver food. But that was not my impression as to the way in which the administration was moving.

My hope would be that perhaps someone—I don't know, the Domestic Counsel's office, or somewhere in the White House—might be able to take a look at S. 1826 with a view toward whether it serves greater the objective of the administration than something that maybe OMB would propose.

Mr. PEARLMAN. Well, first, we will certainly make sure that happens. Clearly, the administration's position is as you described it.

I would just add, not really in disagreement with your comments, that I think it is dangerous to think that simply because an incentive was given through the tax laws that the Government is not in the business. Revenue agents will examine taxpayers and will challenge whether the transportation costs are proper, and they will challenge the value of the food that is given. So we don't keep the Government out of the process simply because a benefit in given through the tax system.

I would suggest that if a grant approach is considered desirable, that is, not having the Government buy trucks and actually doing the transporting of the food, that it would be quite possible to create a checkwriting direct expenditure program whereby transporters could get reimbursed for documented transportation costs, just as in effect they will be reimbursed subject to the tax audit process.

I would just suggest that the tax system is not so clearly an absence of governmental intervention, or that indeed revenue agents are the people to make these kinds of judgments as to value and appropriateness of a particular service.

We will, though, make sure that White House input is gained on this bill.

Senator DANFORTH. I would appreciate that.

On the question of the enhanced deduction for contributions of food, there is now an enhanced deduction for certain taxpayers.

Mr. PEARLMAN. Right.

Senator DANFORTH. But those certain taxpayers do not include taxpayers who are on a cash basis.

Mr. PEARLMAN. Correct.

Senator DANFORTH. That is, a corporate taxpayer not on the cash basis could utilize an enhanced deduction.

Mr. PEARLMAN. That is correct.

Senator DANFORTH. But a noncorporate taxpayer who is on the cash basis could not utilize the enhanced deduction.

Mr. PEARLMAN. Right.

Senator DANFORTH. And farmers who are in the business of producing food are typically not corporate farmers, and they are typically on a cash basis; isn't that right?

Mr. PEARLMAN. Yes.

The cash basis creates a real problem, and I don't know why the provision was limited to corporations previously. But we are concerned about how to deal with the cash-basis taxpayer. Obviously you have reflected that concern in your bill by recognizing that it is very difficult to measure costs, and you have looked at gross receipts. But we think it may well be that by using the gross receipts test you put a potential abuse in the statute which might permit people to profit from this kind of program. We are concerned about that, and we have tried to describe our concerns in our written statement.

Senator **Danforth**. My hope would be that with respect to both 1584 and 1826 we could view your testimony as being certainly well prepared and well articulated but not necessarily the final position of the administration, and that if there is a policy served by the foreign tax credit carryforward, that that should be available to a major and very weak industry such as steel, that we might consider ways of accomplishing the objective. Maybe it would be a little bit different from 1584, but that we could be open to working on that.

With respect to 1826, my hope would be that perhaps the position which you have stated so clearly and so effectively might be reviewed by the White House, to see if this position in this bill does not do a pretty good job of carrying out what I think is the objective of the administration.

Mr. **Pearlman**. We will be happy both to work with you and to make sure that the White House has full input into both bills.

Senator **Packwood**. Thank you, Mr. Secretary. I have no more questions.

Mr. **Pearlman**. Thank you, Mr. Chairman.

Senator **Packwood**. Now, let's move on to S. 1814. We have a panel of Mr. William McCracken, accompanied by William Hallinan; Steve Murphy and Robert Frulla; and Norm Sherlock.

Gentlemen, while we let the Treasury Secretary go on at some length because he had to comment on all of the bills, I would appreciate it if you would limit yourselves to the allotted 5 minutes, and if you can within that time address yourselves to the suggestion of the Secretary of just expensing these rights if they have lost any value, rather than amortizing them.

Mr. McCracken, go ahead.

STATEMENT OF WILLIAM L. McCRACKEN, SENIOR EXECUTIVE VICE PRESIDENT, ACCOMPANIED BY WILLIAM J. HALLINAN, DIRECTOR OF TAXATION, GREYHOUND LINES, INC., PHOENIX, ARIZ.

Mr. **McCracken**. Thank you, Mr. Chairman, Senator Danforth. I am accompanied today, as you noted, by Mr. Hallinan, our executive director of taxes.

We support the bill, Senate bill 1814. We believe it provides a fair and equitable tax treatment to the several thousand bus companies whose operating rights were rendered virtually worthless by the Bus Regulatory Reform Act of 1982.

S. 1814 would allow carriers so affected to deduct the value of those worthless operating authorities over a 60-month period.

It is important at the outset to emphasize that this would not be, and we are not asking for, a change in tax policy. The Senate bill merely insures that taxpayers possessing operating rights which suddenly became worthless can obtain a deduction without lengthy and costly litigation.

The bill is identical, as you noted, Mr. Chairman, to the treatment afforded the truckers after deregulation in 1980. And in that regard I think it is worth noting that the Senate report specifically said, on the bus bill, that entry was to be even easier than that accorded the trucks in 1980. And I would submit that if entry is free for truckers, then it's even more than free for bus companies.

Senator PACKWOOD. In essence are your operating rights, or the old operating rights, now worthless?

Mr. MCCRACKEN. That's our opinion. Yes, sir. I don't think anyone in their right mind would purchase an operating certificate today as they did in the past. As recently as 5 years ago we joined with a small New England carrier, Bonanza Bus Lines, and purchased a certificate for $350,000 that covered 51 miles in length. Today it would be our opinion that that certificate is probably worth the scrap value of a piece of paper.

We are of the opinion—our lawyers are of the opinion—that we are entitled today, under the tax law, to a deduction. But we also believe that that would result in lengthy, possibly 10 years of litigation with the Internal Revenue Service, at great cost to both us and the Government.

Senator PACKWOOD. The Treasury Assistant Secretary seems to think you are entitled to it, also. I take it he isn't speaking for the IRS today, however.

Mr. MCCRACKEN. I would assume he wasn't. And I would assume also that if we were to take it under his theory, we would be faced with endless litigation.

S. 1814 would eliminate all of this uncertainty. It would eliminate the cost of a dispute, a lengthy one. And I think it's fair to say that if a lengthy costly dispute is involved, very few taxpayers are going to go down that road. Most of the smaller companies in the industry presumably would not undertake that lengthy effort with IRS; thus, they would be deprived of a deduction which I think they are entitled to. Thus, all taxpayers under Senate bill 1814 would be treated in a similar manner.

It also, we think, is a fair compromise. On the one hand, the carriers give up the right to take the deduction on their 1982 return, and instead spread it out over 5 years. On the other hand, the Government is not faced with a significant decline in revenue in 1 year, but it is spread out over 5 years.

Last, S. 1814 recognizes that bus regulatory reform has rendered worthless bus operating certificates. As I mentioned earlier, only a few years ago certificates were being sold for substantial sums of money. And they were very useful. They had one useful feature, and I think one only, and that was it conferred either an exclusive or a limited right to operate over a specific route, with competition being limited. That does not exist anymore, and the only useful feature of the certificate is now gone.

Thank you, Mr. Chairman.

Senator PACKWOOD. Thank you.

[The prepared statement of William L. McCracken follows:]

STATEMENT

OF

WILLIAM L. McCRACKEN
SENIOR VICE PRESIDENT AND
ASSISTANT TO THE CHAIRMAN

GREYHOUND LINES, INC.
PHOENIX, ARIZONA

IN SUPPORT OF

S.1814
TAX TREATMENT OF
BUS OPERATING CERTIFICATES

BEFORE THE
UNITED STATES SENATE
COMMITTEE ON FINANCE

SEPTEMBER 26, 1983
WASHINGTON, DC

Mr. Chairman and members of the Committee:

I am William L. McCracken, Senior Vice President of Greyhound Lines, Inc.

Greyhound supports S.1814. The tax laws need to be amended to insure that the tax treatment of operating rights rendered valueless by the Bus Regulatory Reform Act of 1982 is fair and equitable and consistent with that adopted with respect to the operating rights of truckers in the Economic Recovery Tax Act of 1981.

HISTORICAL DEVELOPMENTS HAVE RENDERED HERETOFORE VALUABLE OPERATING RIGHTS WORTHLESS

The Motor Carrier Act of 1935 initiated federal regulation of the motor carrier industry, including buses. Regulation by most states predated that Act, and all others followed. Regulation of buses continued virtually unchanged until November 19, 1982, when the Bus Regulatory Reform Act of 1982 (Bus Act) became effective. The Bus Act effectively eliminated restrictions on entry, thus rendering valueless operating right certificates previously acquired by motor carriers such as Greyhound.

The cornerstone of regulation from 1935 until 1982 was a system of operating rights certification. A carrier was required to have a certificate of Public Convenience and Necessity for each route operated. Obtaining certificates was not an easy task. The statutory burden precedent to issuance of a certificate required that an applicant establish that its proposal was required by the public convenience and necessity. In applying this criteria the Interstate Commerce Commission (ICC) was required to consider:

> "whether the new operation or service will serve a useful public purpose, responsive to a public demand or need; whether this purpose can and will be served as well by existing lines or carriers; and whether it can be served by the applicant ... without endangering or impairing the operations of existing carriers contrary to the public interest." Pan-American Bus Lines Operation, 1 MCC 190 (1936).

This was an exceedingly difficult burden to meet in the face of opposition by an existing operator. As a result, certificates were generally acquired through purchase after application to and a finding by the ICC that the acquisition was in the public interest.

Greyhound acquired its operating certificates generally as a result of acquisitions of other bus companies.

In 1980 Congress commenced deregulation of the motor carrier industry by virtually eliminating regulation of entry into the trucking industry through passage of the Motor Carrier Act of 1980.

On November 19, 1982, as a result of the Bus Regulatory Reform Act of 1982 (Bus Act), entry requirements into the intercity bus industry interstate and intrastate likewise were virtually eliminated thus immediately rendering previously acquired certificates worthless. Between 1980 and 1983 the states of Florida, Arizona, Wisconsin, Michigan, Indiana, and Maine enacted legislation deregulating the bus industry. In each case, the effect was to extinguish the value of the operating certificates owned by the affected carriers.

Congress clearly intended to dramatically reduce barriers to entry. In fact the barriers are lower than for trucks where entry has become virtually automatic.

> "... under this bill, entry will be easier than it is for motor carriers of property under the Motor Carrier Act of 1980." Senate Report 97-411, May 20, 1982, Committee on Commerce Science and Transportation.

In the five years preceding the Bus Act, applications for new regular-route operating certificates averaged 60 annually. In the first 10 months under the Bus Act they are being filed at an annual rate of 250 applications, an increase of 316%.

The numbers alone do not tell the whole story. The applications filed under the Bus Act are dramatically greater in scope and geographical coverage than those filed pre-Bus Act.

Prior to the Bus Act regular-route applications were few in number; involved small route segments recognizing highway developments; and were often over routes served by no other carrier. The few significant applications resulted in weeks if not months of hearings and court appeals, and, if eventually granted, it was two, three, even four years after the initial application.

The Bus Act has changed this to make certification virtually automatic. The result has been a dramatic increase in major route extensions by established carriers and significant new route systems by newcomers to the industry.

The following are some examples of significant route applications, under the Bus Act where the time between filing and initial operation approximated 90 days. These same applications under the previous regulatory scheme would have in all probability been protested by incumbent carriers, and the regulatory process would have consumed two to five years. And even then the probability of denial of the application was substantial.

Examples of Major Routes Where Authority Has Been Sought, Obtained and Operations Commenced Under Bus Regulatory Reform Act of 1982

Cleveland - Columbus - Cincinnati
Toledo - Cincinnati
Chicago - Cairo
St. Louis - Kansas City
San Francisco - Sacramento
Houston - Baton Rouge
Norfolk - Richmond
Cincinnati - Louisville
Detroit - Flint
San Diego - Los Angeles - San Francisco
Peoria - Davenport

A major growth area in the bus business is the charter and special operations area. This is service for preformed groups or service that is destination oriented. In the first ten months under the Bus Act 1,626 applications were filed for charter and special operations authority, almost all nationwide in scope. Annualized, this is a 599% increase over the average number of applications filed annually in the prior five years.

Under the prior law the public convenience and necessity entry test applied. Litigation was frequent and authority issued was fragmentary in scope. Carriers generally could originate charters and special operations only in specified areas, i.e. a county or city.

Under the Bus Act, an applicant merely assures the Commission that it has insurance and will operate safely. An established carrier has no other grounds for protest. Also, authority granted under the Bus Act is almost always nationwide in scope, allowing a carrier to originate a movement at any point in the U.S. destined to any other U.S. locality.

It is inconceivable that a person today would purchase a motor carrier operating certificate. The elimination of substantive regulatory entry barriers means a person can obtain a certificate from the ICC in less time than it would take to obtain authority from the ICC to purchase a certificate and with less paperwork because the ministerial requirements for a new certificate are far less than those to purchase a certificate. In view of the ease with which a certificate can be obtained there is no economic or business reason to purchase a certificate. A certificate is valueless, it amounts to not much more than a business license which one obtains for the asking.

It is clear that a certificate, once an exclusive, valuable and marketable right to do business is now nothing more than the equivalent of a certificate of good standing.

Equitable Tax Policy Requires a Tax Deduction For Operating Rights Rendered Valueless by the Bus Act

A basic and long standing principle of income tax law requires that a business taxpayer be permitted to exclude its reasonable business expenses, including the cost of an asset, in determining income. If an asset is sold, taxable gain or loss is computed by subtracting its cost from the sale proceeds. If, prior to sale, the asset is determined to have a limited useful life it is depreciable or amortizable, its cost being recoverable through deductions from income over a specified period of time. If an asset, which is neither sold nor depreciated or amortized, becomes worthless, the taxpayer is entitled to recover the asset's cost through a tax deduction for the loss.

Greyhound, like numerous other motor carriers, acquired by purchase over a period of years the rights to operate buses over numerous routes regulated by the ICC and the comparable regulatory agencies of each of the states. Under the income tax law, the substantial costs incurred in acquiring such operating rights were treated as being neither depreciable nor amortizable. Accordingly, except for occasional sales of minor rights, Greyhound obtained no tax benefit through recovery of the cost of, such purchased operating rights such as the depreciation or amortization deductions allowed with respect to other business assets. As a consequence of deregulation of the interstate bus industry through enactment of the Bus Act, operating rights became worthless. Carriers thereupon became entitled to claim an income tax deduction for their loss in the full amount of the capitalized tax cost of their operating rights.

Although Greyhound's tax counsel is firmly of the opinion that deregulation of the bus industry destroyed the value of the operating rights, and that the resulting loss is fully deductible, Greyhound recognizes that questions arose following deregulation of the trucking industry and that a lengthy and costly dispute with the Internal Revenue Service might ensue in connection with deregulation of the bus industry. Therefore, in order to put all such questions to rest and to fairly protect the interest of Greyhound and similarly situated bus companies, as well as to protect the proper interests of the Government with respect to consistent and sound tax administration, Congress should provide an appropriate legislative solution to the problem.

In connection with the adoption of the Motor Carrier Act of 1980, the Financial Accounting Standards Board determined that interstate motor carrier operating rights had become worthless and should be immediately charged to income (FASB-44). Notwithstanding, the Internal Revenue Service raised questions about the tax treatment with respect to such rights.

Congress foresaw the asset loss and in its report with respect to the Motor Carrier Act of 1980 recommended:

> "... appropriate (legislative) relief for such result should be considered as early as possible. Preferably by the Committee on Ways and Means." (House Report No. 96-1069, June 3, 1980.)

As a result, Congress adopted a provision in the Economic Recovery Tax Act of 1981 that allows the trucking industry an ordinary, 60-month tax deduction for the lost value of motor carrier operating rights.

Bus carriers, such as Greyhound, having paid substantial amounts to obtain operating rights in connection with their businesses, now find themselves holding rights without market value. While the Internal Revenue Code and Regulations recognize the long-standing tax policy of allowing a business a current deduction for a loss sustained and not compensated for by insurance or otherwise, it could be argued that a deductible loss has not occurred. Therefore, bus carriers are faced with the prospect of possible prolonged litigation and uncertainty of result from any attempt to deduct the cost of such rights for tax purposes., Without a legislative mandate -- which fairness and equity dictates -- such prospect and uncertainty will adversely affect the industry and unnecessarily create administrative problems for the IRS. We therefore support S.1814.

Equality of treatment for all affected taxpayers is an absolute necessity to sound economic and tax administration. First, a tax deduction of operating rights should be automatic. This will result in equal treatment for taxpayers large and small. Deductibility will not result just for those willing to invest in a lengthy controversy with the tax collector. S.1814 would accomplish that result.

Second, all operating rights have been deprived of value and thus their total value should be deductible. There should be no arbitrary minimum threshold of value before deductibility occurs nor an arbitrary maximum deductible amount. To impose either a minimum or maximum would be unjustly discriminatory, would further no discernible public policy, and would override long-standing national tax policy. The degree to which taxpayers invested in operating authority is irrelevant. What is relevant is that the rights have lost all value and the business taxpayers are entitled to a full deduction of their investment.

In conclusion, Greyhound supports enactment of S.1814 as an equitable and fair answer to the tax treatment of operating rights rendered valueless by the Bus Act.

Senator **Packwood**. Mr. Murphy.

I might welcome Mr. Murphy here, who I've had long dealings with as a member of the Motor Carrier Ratemaking Study Commission, and he is one of our most articulate members.

Steve.

STATEMENT OF STEPHEN P. MURPHY, SENIOR VICE PRESIDENT AND SECRETARY, YELLOW FREIGHT SYSTEM, INC., OVERLAND, KANS., AND ROBERT J. FRULLA, PRESIDENT, FREIGHT FORWARDERS INSTITUTE, WASHINGTON, D.C.

Mr. **Murphy**. I appreciate your kind comment, and I appreciate the chance to testify.

Mr. Frulla, on my left, is the president of the Freight Forwarders Institute, which is the national group of domestic freight forwarder common carriers.

Basically what we are asking for is the same inclusion that the truck operators got under the 1981 act. Now, the question someone asked me this morning was, "Well, why didn't you get it in 1981?" Well, the big reason that we really didn't is that it was the Motor Carrier Act that was involved, and everybody felt that if we asked about freight forwarders at that time, not being sure that that the write-off would ever be approved, that we might foul up the situation. So we never bothered to ask at that time. And as a result, really beginning in about 1978–79, for example, Yellow Freight System, the parent of our own freight forwarder—and I am speaking for other freight forwarders now—we never protested any cases for operating rights after 1978 at the Interstate Commerce Commission because we saw deregulation coming. And basically we—yellow—were the largest, as perhaps you may be aware, of any of the carriers in the write-off of operating authority. Ours, on the truck line, was $34.5 million—it was the largest of any motor carrier, because we had been engaged in this business of acquiring operating authority on a very extensive program over many years.

And in 1980, when the deregulation came along and open entry into the truck lines came along, the Commission, really by fiat or de facto, did the same thing. And if you look at my statement, in the back, you can see how many applications are granted.

I would for a moment, if I could, just deal with what the spokesman for the Treasury said. He said they, you know, are working out some values on these authorities or something. But he also said that maybe this should be done all at once. We would be happier to do it that way than over 60 months.

The effect, incidentally, tax-wise for our program is $3 million. But what I would like to say is this: When deregulation first got started, to give you an example, the Treasury man said that these authorities still had value. On behalf of Yellow Freight System, I applied for nationwide authority under various programs, trying to put together irregular route and regular route, and I was challenged twice in the Fifth Circuit Court of Appeals. So that when the dust finally settled, Yellow Freight System, the truck line today, for example, holds operating authority to all points in the United States under four different certificates. Now, as to whether those certificates have any value, they cost $350 apiece to get, I'd offer them 90 percent of anything over $350 for them. [Laughter.]

Mr. MURPHY. It's just not fair. They've been deregulated. And I think that is really the thrust of what is involved in this case. I don't want to belabor the point, but I would be happy to answer any questions you might have.

Senator PACKWOOD. We'll let Mr. Sherlock go first, and then I do have some questions.

[The prepared statement of Stephen P. Murphy follows:]

STATEMENT OF STEPHEN P. MURPHY
YELLOW FREIGHT SYSTEM, INC.
ON BEHALF OF THE
FREIGHT FORWARDERS INSTITUTE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

SEPTEMBER 26, 1983

SUMMARY

The once-valuable ICC permits of freight forwarders, like those of motor carriers and buses, have been rendered worthless by deregulation. The Economic Recovery Tax Act of 1981 clarified existing law by providing a deduction for the devalued operating rights of motor carriers. S. 1814, introduced by Chairman Packwood, would provide a comparable deduction for bus operating rights. The Freight Forwarders Institute requests the Committee's support for legislation to provide a similar deduction for freight forwarder operating rights. The legislation is supported by principles of fairness and equity -- and by the same sound tax policies underlying the motor carrier and bus legislation.

In some important respects, indeed, the case is more compelling for freight forwarders than it is for trucks or buses. In *every* respect, it is at least as compelling as the case for these other two transportation modes.

1. Meaningful ICC entry restriction of freight forwarders has ended. The grant rate has been effectively 100 percent for several years. *De facto*, administrative deregulation began earlier and ran deeper for freight forwarders than it did for motor carriers.

2. The statutory entry provisions for freight forwarders and buses are virtually identical -- and both are significantly less restrictive, more pro-competitive, than the governing motor carrier statute.

3. The Motor Carrier Act of 1980, as interpreted and applied by the Interstate Commerce Commission, has had a profound effect

on the regulation of freight forwarders. Like much of the motor carrier industry and the American Trucking Associations, many forwarders and the Institute do not agree with the full extent of the Commission's interpretation of the statute, but it is nonetheless a fact of our economic and regulatory life.

From the point of view of tax policy, the critical point is that motor carriers, passenger carriers and freight forwarders, whatever the differences of their regulatory situations, all have had their certificates rendered worthless by a fundamental change in governmental entry policy. They should all be afforded the same tax treatment. The revenue impact of a tax deduction for freight forwarders is approximately 3 million dollars -- small in comparison to the impact of the motor carrier and bus provisions. The Freight Forwarders Institute requests the Committee's support for legislation to give forwarders the same ordinary deduction for their permits as that provided for the certificates of motor carriers and proposed for the certificates of passenger carriers.

STATEMENT OF STEPHEN P. MURPHY
ON BEHALF OF THE
FREIGHT FORWARDERS INSTITUTE

Thank you Mr. Chairman and members of the Subcommittee for the opportunity to appear before you concerning S. 1814. I appear to request on behalf of the Freight Forwarders Institute that the sound principles underlying S. 1814 also be applied to freight forwarders.

My name is Stephen P. Murphy. I am Senior Vice President and General Counsel of Yellow Freight System, Inc., headquartered in Overland Park, Kansas. With me is Mr. Robert J. Frulla, President of the Freight Forwarders Institute, a national association of the regulated, domestic, common-carrier freight forwarding industry.

Though perhaps less well recognized than other common carriers, freight forwarders are an integral part of our surface freight transportation system. A forwarder takes freight from shippers, usually in small shipments, combines it with freight of other shippers, and sends it on its way via some other carrier, usually a motor common or contract carrier. Forwarders are, on the one hand, closely integrated with motor carrier operations, and, on the other hand, meet motor carriers in head to head competition.

Mr. Chairman, we appear before you today to request equitable tax treatment for freight forwarders. Like motor carriers and buses, freight forwarders have had their once-valuable ICC permits rendered worthless by deregulation. The Economic Recovery

Tax Act of 1981 correctly and justifiably clarified existing law to permit motor carriers a deduction for their worthless certificates. S. 1814 correctly and justifiably provides bus companies with a deduction for their worthless certificates. The Freight Forwarders Institute seeks your support, Mr. Chairman, and that of the Committee on Finance, for legislation which would provide the same tax treatment for freight forwarders' permits. The legislation we propose has been introduced on the House side by Rep. Kennelly as H.R. 3528. It is supported by the same sound tax policy which underlies the motor carrier and bus provisions.

Indeed, Mr. Chairman, in many significant respects, the case for such a provision for freight forwarders is even stronger than the case for the other two types of carriers. In every significant respect, it is at least as strong. Let me put the point slightly differently: While there are differences in the regulatory status of freight forwarders, motor carriers and buses, there exists no difference which justifies, from the point of view of sound tax policy, differing tax treatment of their worthless certificates.

I wish to make three basic points with respect to the deregulation of freight forwarders: (1) meaningful entry restriction no longer exists; (2) the existing statutory entry standards applicable to buses and freight forwarders are virtually identical, and both are even less restrictive than the motor carrier criteria, and (3) the Motor Carrier Act of 1980, as interpreted by the Interstate Commerce Commission, has had a profound impact on the regulation of freight forwarders.

1. Meaningful entry restriction no longer exists for freight forwarders. For an ICC license to have significant value, it must represent a "scarce" commodity and it must create some benefit in terms of exclusion of competition. The ICC entry policy relating to it must meaningfully limit the number of competitors who can be licensed and thus meaningfully limit the competition the licensee faces. Just as it has for motor carriers and for buses, entry policy administered by the Commission has ceased serving that function.

I know of no knowledgeable person who contests the proposition. Indeed, it is even more clearly the case for freight forwarders than for motor carriers.

The numbers are the best evidence. Attached to this testimony as "Exhibit A" is a chart setting out in detail the freight forwarder grant rate for the years 1958 through 1967, and for the years 1977 to the present. (The Commission stopped keeping these statistics in 1967 and did not begin again until they computerized in 1977.) What these numbers show is a grant rate of effectively 100 percent at least since 1977. And, they further show, as the word spread in the transportation industry, a steadily growing number of applications. Since passage of the Motor Carrier Act in 1980, out of a total of 296 applications, only 9 have been denied "on the merits." We have examined those nine cases listed in Commission statistics as denials. Two of them were actually grants, with the grant coming on appeal of the initial negative decision. 1/

1/ Imperial Carriers, Inc. Extension - Nationwide General Commodities, No. FF-416 (Sub-No. 3)(served Apr. 28, 1982)(granted

Footnote continued on pg. 4

Three were denied because the applicant already held authority as a common carrier, contract carrier or licensed broker. [2/] The other four denials, all by employee review boards, were based upon the applicant's failure to make a sufficient showing of proposed operations or shipper support to make even a prima facie showing of public need. [3/] There exists no significant restriction of freight forwarder entry.

"Exhibit B" to my testimony sets out the motor carrier grant rate since 1976. An examination of that chart reveals that the motor carrier grant rate on the merits did not become effectively 100 percent until 1979 or 1980 -- at least several years after the doors were thrown wide open to forwarder applicants.

The open entry policy regarding forwarder permits of the last six years contrasts with the severely restrictive policy exercised during the 1958 to 1967 period, as shown in the chart. During that period, the grant rate on the merits averaged about

---

1/ Footnote continued from pg. 3

in decision served July 29, 1982); U.S. Express, Inc., Freight Forwarder Application, No. FF-578 (served Mar. 8, 1982)(granted in decision served May 17, 1982).

[2/] Slay Transportation Co., Inc., Freight Forwarder Application, No. FF-625 (served Mar. 14, 1983); APX International, Inc., Freight Forwarder Application, No. FF-580 (Sub-No. 1)(served Aug. 3, 1982); and Cosmopolitan Forwarders, Ltd., Freight Forwarder Application, No. FF-551 (served Aug. 18, 1981).

[3/] Airborne Forwarding Corporation Extension - United States, No. FF-392 (Sub-No. 4)(served May 26, 1982); Atlas Consolidated Container, Inc., Freight Forwarder Application, No. FF-573 (served Feb. 26, 1982); CTC Forwarding Company, Inc., Freight Forwarder Application, No. FF-555 (served Nov. 17, 1981); and Bonney Forwarding, Inc., Freight Forwarder Application, No. FF-549 (served Aug. 19, 1981).

60 percent, and the average number of applications per year was only 15, compared to an average of 60 applications for the years since 1977. The low grant rate and low number of applications from 1958 to 1967 reflect the importance placed by the Commission during the period upon the factor of "adequacy of existing service," i.e., protection of existing competitors, in deciding on forwarder applications. A clear statement of this philosophy is contained in Frank P. Dow Co., Inc., Extension - Longview, No. FF-173 (Sub No. 1), 16 CCH FEDERAL CARRIER CASES ¶ 35,711 (January 13, 1964). See also D.C. Andrews & Co. of Illinois, Inc. Extension - Baltimore Maryland, No. FF-36 (Sub No. 3), 1966-67 CCH FEDERAL CARRIER CASES ¶ 36,032 (July 21, 1966); H.E. Sutton Freight Forwarder Application, No. FF-323, 1966-67 CCH FEDERAL CARRIER CASES ¶ 36,139 (September 18, 1967); New England Forwarding Co. Extension, Import Export, No. FF-96 (Sub No. 2), 1968-1970 CCH FEDERAL CARRIER CASES ¶ 36,317 (May 17, 1968); Acme Fast Freight, Inc. v. United States, 1968-1970 CCH FEDERAL CARRIER CASES ¶ 81,973 (December 10, 1967).

In the 1970's, the ICC began slowly and steadily deregulating. Deregulation of forwarders moved at a faster pace than that of motor carriers. The main reason for this was that the forwarder entry criteria were inherently less restrictive than the motor carrier entry criteria. The ICC had recognized as early as 1966 that the "public interest" test applicable to freight forwarders was more liberal than the "public convenience and necessity" test applicable to motor carriers. D.C. Andrews & Company of Illinois, Inc., Extension - Baltimore Md., supra. Beginning in approximately 1973, the Commission increasingly began to emphasize this point and correspondingly, began to downplay the importance of protecting existing competitors. The Commission's approach, and its underlying interpretation of the statute, were confirmed by the courts. See, e.g., Yellow Forwarding Co. v. United States, 1973-76 CCH FEDERAL CARRIER CASES ¶ 82,464 (D. Kan. 1973); Aloha Consolidators International v. United States, 1973-76 CCH FEDERAL CARRIER CASES ¶ 82,583 (D. Col. 1975). The explicit relaxation of entry standards was steady and progressive. As will be discussed at a later point in my testimony, the year 1980, with the passage of the pro-competitive Motor Carrier Act, marked its culmination.

Freight forwarder permits are worthless for the same reason motor carrier and bus certificates are: The Commission no longer meaningfully restricts entry. Moreover, with respect to freight forwarders that fact is clearer, and longer-established, than it is with respect to trucks and buses -- and even for trucks and buses it is very clear and very well established.

2. The statutory entry criteria applicable to freight forwarders are virtually identical to the newly-enacted bus criteria, and both the forwarder and bus criteria are more liberal than the motor carrier criteria. The Commission's open-entry policy for freight forwarders is, as indicated in the foregoing portion of my testimony, solidly tied to the relevant statutory criteria. It has been endorsed by the courts. It has been sealed and solidified by the pro-competitive Motor Carrier Act of 1980. It has produced a flood of new competitors for freight forwarders. There can be no turning back. We may not like that, but we are resigned to it. It is a fact of our economic and

business life. Reregulation of motor carriers or freight forwarders, so as to restore value to their certificates, is not a realistic possibility. Anyone who would argue to the contrary could not, in any event, argue with this proposition: Based on the relevant statutory provisions, if reregulation is possible, it is "more possible" for motor carriers than for freight forwarders.

Freight forwarder entry is governed by a "consistent with the public interest" standard. 49 U.S.C.A. § 10923(a)(2) (West Supp. 1983). As related above, this standard has been definitively interpreted by the Commission and the courts to place much less importance on considerations of protecting existing competitors than the traditional "public convenience and necessity" test applicable to motor carrier licensing. Indeed, in enacting the pro-competitive Bus Regulatory Reform Act of 1982, Congress adopted the "consistent with the public interest" standard. 49 U.S.C.A. § 10922 (c)(1)(A) (West Supp. 1983). Because of a slight difference in the wording of the two provisions, however, the bus provision reflects a clearer placement of the burden upon protesting carriers seeking protection from competition. Nonetheless, as the Senate Commerce Committee report states, this placement of the burden is of subordinate importance: "It should be clearly understood, however, that the burden placed upon protestants is not insurmountable and that the entry test should not be treated by the ICC as a regulatory charade." S. Rep. No. 411, 97th Cong., 2d Sess. 16, *reprinted in* 1982 U.S. Code Cong. & Ad. News 2308, 2323.

The consistent with the public interest standard applicable to buses and forwarders is less restrictive than the criteria applicable to motor carriers under the Motor Carrier Act of 1980.

The Senate Commerce Committee report on the bus bill states as follows:

> The new public interest requirement will also make it easier for applicants to obtain operating certificates. The Committee intends that this test be interpreted as a substantially lesser entry standard test than the traditional public convenience and necessity standard. In fact, under this bill, entry will be easier than it is for motor carriers of property under the Motor Carrier Act of 1980.

S. Rep. No. 411, supra, 15, reprinted in 1982 U.S. Code Cong. & Ad. News 2308, 2322.

The fact of the matter is that the entry policy which has rendered truck and bus certificates worthless is dependent, to some critical extent, on the Commission's application and interpretation of the relevant statutes, informed by the general pro-competitive national transportation policy declared by Congress. Standing alone, the statutory provisions do not mandate the full extent of the open-entry policy. The certificates are, nonetheless, worthless.

The same is true of freight forwarders. Commission interpretation and application, confirmed by the courts, necessarily plays a role. The statute does not end the matter. Forwarders, like motor carriers and buses, have had their permits rendered worthless by the ICC, a creature of Congress acting pursuant to a Congressional delegation of authority. The process will not be reversed. However, if one were to argue that it could be reversed, even theoretically, one would also have to admit that, on the basis of the relevant statutory provisions, it could be reversed about as easily for buses and even more easily for trucks.

3. The Motor Carrier Act of 1980, as interpreted by the Interstate Commerce Commission, has had a profound effect upon freight forwarder regulation. The Act did not amend the entry criteria applicable to freight forwarders. It did not have to. The existing criteria, as discussed in the previous portion of my testimony, were already more liberal than the criteria which the Motor Carrier Act put in place for motor carriers of property.

The most basic way in which the Act furthered freight forwarder deregulation was by establishing the fundamental pro-competitive national transportation policy by which the remaining regulation of the motor carrier industry, and the integrally related freight forwarder industry, was to be conducted.

Indeed, in the Freight Forwarders Institute's view, the Commission has gone to unreasonable lengths in taking specific provisions of the Act which, by their terms, apply only to motor carriers and applying them wholesale to forwarders. The clearest case in point concerns the restriction removal provisions of the Act. Even though the special procedures and relaxed standards for restriction removal of the Act apply only to motor carriers, the Commission, in Ex Parte No. 142 (Sub No. 2) decided to make them applicable to freight forwarders as well. In the course of its decision the Commission cited its traditional "policy of parity in treatment of these two types of regulated entities," "the close operational relationship between motor carriers and freight forwarders," the Act's pro-competitive changes in the National Transportation Policy, its intent to encourage intermodalism, and its setting of the deregulatory "tone" for the regulatory structure. The U.S. Court of Appeals for the Fifth Circuit held just last week that the Commission cannot take so specific a section of the statute and apply it wholesale to forwarders without Congressional authorization. Global Van Lines, Inc. v. ICC, No. 82-4284 (5th Cir. Sept. 19, 1983). But that is not the point. Whether or not the Commission can go this far in a specific area, Ex Parte No. MC-142 (Sub No. 2) and the reasoning on which it is based are vivid examples of the pervasive effect of the Motor Carrier Act of 1980 on forwarder regulation. Whether or not the Commission can adopt the Act's specific restriction removal rules for direct application to freight forwarders, it can and has applied the Act's deregulatory thrust to its freight forwarder entry decisions in particular and to its regulation of forwarders in general.

Another important, fundamental, point needs to be made concerning the impact of the Act on freight forwarders. While freight forwarders cooperate closely with motor carriers in providing service, we are also directly in competition with motor carriers. We offer the same service to shippers, particularly with respect to small shipments, as the L-T-L carriers of general commodities do. The mere fact of motor carrier entry liberalization, apart from freight forwarder entry, dramatically reduced the worth of our permits. Liberal motor carrier entry itself has confronted us with more, and bigger, competitors.

The Motor Carrier Act of 1980, as interpreted by the Interstate Commerce Commission, to repeat my basic and important point, has had a profound and pervasive effect on freight forwarders.

Mr. Chairman, before closing, let me briefly address some of the more narrow "tax" aspects of our proposed legislation. We break no new ground here. Our legislation is identical in all important respects with the already enacted motor carrier provision and your proposed bus legislation. Like those statutes, our proposal provides for a 60-month amortization period for the deduction. I should note that our proposal, like the motor carrier provision, begins the authorization period after July, 1980, the date of passage of the Motor Carrier Act. As explained above, it was on this date that the worthlessness of freight forwarder permits was definitively established.

We estimate the revenue impact involved in our proposal at a maximum of $3 million. This is certainly small in comparison even to the modest impact of the bus and motor carrier provisions. Indeed, as was the situation with motor carriers, and as is the situation with buses, it is arguable that existing law, apart from the statutory provisions, allows a deduction for the worthless rights. The proposed legislation would clarify the law and avoid costly and wasteful litigation. Under this view, there would be no negative revenue impact.

Mr. Chairman, I urgently request your support and the support of the Finance Committee for our proposed legislation. The legislation is supported by sound tax policy. Moreover, to fail to afford freight forwarders the same treatment as motor carriers and passenger carriers, would be, in our sincerely-held view, inequitable and unfair.

Grant Rate on Freight Forwarder Applications Exhibit A

Fiscal Year	Total	Granted	Denied	Dismissed, Withdrawn, Not Decided	Total Grant Rate	Grant Rate On Merits
1958	4	2	0	2	50%	100%
1959	2	1	1	0	50%	50%
1960	39	5	2	32	13%	71%
1961	15	3	1	11	20%	75%
1962	14	8	3	3	57%	73%
1963	8	4	3	1	50%	57%
1964	14	7	2	5	50%	78%
1965	14	6	4	4	43%	60%
1966	17	4	7	6	24%	36%
1967	21	10	9	2	48%	53%

Weighted Average = 61%

[The ICC discontinued reporting freight forwarder grant rate statistics in 1967. The information is not again available until 1977, when the ICC began to keep its statistics on computer.]

Calendar Year	Total	Granted	Denied	Dismissed, Withdrawn, Not Decided	Total Grant Rate	Grant Rate On Merits
1977	54	52	1	1	96%	98%
1978	25	20	2	3	80%	91%
1979	16	12	2	2	75%	86%
1980	34	31	--	3	91%	100%
1981	71	58	3	10	82%	95%
1982	99	79	5	15	80%	94%
1983 (to 8/31/83)	92	82	1	9	89%	99%

Weighted Average = 96%

Exhibit B

Grant Rate on Motor Carrier Applications

Fiscal Year	Total	Granted	Denied	Dismissed, Withdrawn, Not Decided	Total Grant Rate	Grant Rate On Merits
1977	7,848	6,038	984	826	77.0%	86.0%
1978	9,767	8,684	384	699	88.9%	95.8%
1979	12,944	12,233	200	511	94.5%	98.4%
1980	22,735	22,125	97	513	97.4%	99.6%
1981	28,414	27,475	231	708	96.7%	99.2%
1982	15,553	14,786	147	620	95.1%	99.0%
1983 (to 4/1/83)	6,646	6,323	24	299	95.1%	99.6%

Weighted Average = 97.9%

Senator **Packwood**. Mr. Sherlock, president of the American Bus Association.

STATEMENT OF NORMAN R. SHERLOCK, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN BUS ASSOCIATION, WASHINGTON, D.C.

Mr. **Sherlock**. Thank you, Mr. Chairman, Senator Danforth.

For the record, my name is Norman Sherlock, president and chief executive officer of the American Bus Association, a national organization which represents the private inner-city bus industry. With a fleet of about 21,000 buses, last year we transported some 370 million passengers.

The association has a membership of about 3,000, consisting of bus operators in all forms of service as well as many businesses which are engaged in travel and tourism in just about every State in the Union.

Individual bus companies have become a vital component and in many cases the lifeline of the travel and tourism industry, for an industry which contributes about $140 billion a year to the national economy.

I am here today to express support for S. 1814. The operating rights in question in this hearing are worthless, in our estimation, because of deregulation. And a modification needs to be made to the Internal Revenue Code to permit their amortization, as has already been done with the trucking industry.

The sudden loss in value of these operating rights has had a very negative effect on the financial position of many bus companies, and it is for this reason that we testify in support of the legislation. A significant reduction in net worth to the holders of these operating authorities has made it difficult to raise capital at a time when the industry is attempting to upgrade its fleet with more fuel efficient, economical buses. With the average bus costing $145,000 to $160,000 today, the ability to borrow capital is very crucial to our continued wellbeing.

The passage of this bill would clarify the present confusion which exists regarding the tax treatment of the worthless operating rights. The Economic Recovery Tax Act of 1981, while perhaps offering general guidance to bus companies, is specifically limited to carriers of property who held such operating rights on July 1, 1980. The legislative clarification as to how this worthless asset should be treated for tax purposes would eliminate the need for costly legal and tax-accounting assistance.

This legislation in our view is also warranted in terms of sound tax administration. This is the first full taxable year following bus deregulation. If the legislation were to pass in 1984 or even 1985, it would result in the filing of thousands of amended returns with the Internal Revenue Service, an agency which is already severely overburdened, and it would also add inconvenience and expense to our membership.

Let me briefly comment on the statement presented by the spokesman for Treasury.

First of all, Treasury appears to be concerned about a precedent being established. If you look at page 6 of our testimony, you will note that there is ample precedent already in the form of bank holding company rules, people who have been treated with the SEC and the FCC, coupled with the fact that it is already in place for the truckers. So the question of precedent really is not a good one at this point.

Second, they have said that these rights continue to have values in the trucking industry because the ICC required the taxpayer to secure the rights in order to go into the business. As you have already noted, Mr. Chairman, that really means nothing. And the same is true of the bus industry today. You can get an authority to operate virtually by return mail. It is simply a piece of paper, and that's all it's worth.

Third, they say that they think losses should be recognized on the basis of an identifiable event. I think certainly deregulation in this legislative form that occurred last year and went into effect in November is an identifiable event.

Fourth, the spokesman seemed to be leaning in the direction of treating our operating rights as a business related loss, which would in effect result in a 1-year write-off. That would be all right with us, if we could be absolutely certain that that would be the policy that would be followed. If in fact Treasury were to submit a letter and amend its regulations to make it clear that that is the policy. Nonetheless, Mr. Chairman, we do prefer a clear legislative solution.

Thank you very much.

Senator **Packwood**. But as between the two, you would prefer a legislative solution that says write them off in one year, rather than amortization.

Mr. **Sherlock**. Absolutely.

[Mr. Sherlock's prepared statement follows:]

ABA
AMERICAN BUS ASSOCIATION
1025 CONNECTICUT AVENUE, N.W., WASHINGTON, D.C. 20036 (202) 293-5890

STATEMENT OF THE AMERICAN BUS ASSOCIATION
CONCERNING S. 1814,
A BILL TO ALLOW AN AMORTIZATION DEDUCTION
FOR
OPERATING RIGHTS,
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE, UNITED STATES SENATE
BY
NORMAN SHERLOCK, PRESIDENT AND CHIEF EXECUTIVE OFFICER
AMERICAN BUS ASSOCIATION
September 26, 1983

THE NATIONAL ORGANIZATION OF THE INTERCITY BUS INDUSTRY

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to testify on behalf of the ABA in favor the S.1814. My name is Norman Sherlock. I am President and Chief Executive Officer of the American Bus Association.

The American Bus Association is the national trade association for the inter-city bus industry. With a fleet of some 21,000 buses, the industry transported 370 million passengers in 1982. The Association has a membership of nearly 3,000, including bus owners and operators and others engaged in travel and tourism. Individual bus companies have become a vital element and, in some cases, the lifeline for travel and tourism which contributes $140 billion annually to the Nation's economy.

We are here today to express our support for S.1814, which would provide for the amortization of bus operating rights. It is the position of the Association that because these operating rights are now worthless because of deregulation, a modification should be made to the Internal Revenue Code to permit their amortization, as has already been done with the trucking industry.

In 1935, Congress amended the Interstate Commerce Act by passing the Motor Carrier Act. The purpose of the legislation was to provide a regulatory framework for motor carriers of both freight and passengers. The primary regulatory feature of the Act was the establishment of a system of operating authorities or "rights" by which a motor carrier gained an exclusive concession to operate along a certain route.

During the period 1935 to 1980, the Interstate Commerce Commission (ICC) granted a limited number of permits and certificates of operating authority to motor carriers and freight forwarders. In order to secure a certificate of operating authority, the applicant was required to prove that:

1. The applicant was fit, willing and able to provide the transportation and comply with the ICC regulations, and;

2. That the transportation to be provided was or would be required by the present or future public convenience and necessity.

Holders of existing operating rights were empowered to intervene in a proceeding for a request of operating authority to show that the proposed service was not required by the public convenience and necessity.

The right of existing operators to intervene and the applicant's burden of showing that the proposed service was required by the public convenience and necessity gave existing operators some protection against unwarranted competition. Persons wishing either to enter the motor carrier business or expand an existing business, often would purchase an existing business with its operating authority.

Substantial amounts were paid for these operating authorities. The value of the operating authorities provided owners with an asset that constituted a substantial part of a carrier's asset structure and a valuable source of loan collateral.

In 1979 and 1980, Congress undertook a study of motor carrier regulation and eventually approved the Motor Carrier Act of 1980 (PL 96-266), deregulating the trucking industry. Until the passage of the 1980 Act, both passenger and freight motor carriers were under the regulatory sanctions of the 1935 Act. Since the 1980 Act dealt only with motor carriers of property, the bus industry continued to be regulated under the 1935 legislation.

In its report on the 1980 Act, the House Public Works and Transportation Committee addressed the issue of operating rights by noting that if it should "become apparent that the effect of this legislation has been to substantially erode the value of operating rights, then appropriate relief for such results should be considered, as early as possible." [1]

The Congress did apparently find that the value of these rights was eroded since it granted tax relief in the same year that it passed the legislation to deregulate the industry. Such relief was included as part of the Economic Recovery Tax Act of 1981 (ERTA)(PL 97-34). Specifically, § 266 of ERTA states that, for taxpayers who, on July 1, 1980, held one or more motor carrier operating authorities, "an amount equal to the aggregate adjusted basis of all

---

1/ H.R. Rep. No. 1069, 96th Cong., 2nd Sess. 4, reprinted in 1980 U. S. Code Cong. & Ad. News 2286 motor carrier operating authorities held by the taxpayer on July 1, 1980, or acquired subsequent thereto pursuant to a binding contract in effect on July 1, 1980, shall be allowed as a deduction ratably over a period of 60 months."[2]

On November 19, 1982, the Bus Regulatory Reform Act of 1982 (PL 97-261) became law. This legislation, which deregulated the inter-city bus industry, removed almost all barriers to entry into existing markets, established new guidelines for the bus industry's rate bureau, limited anti-trust immunity, and amended the minimum levels of financial responsibility required of bus operators. One of the most far reaching aspects of the legislation was the increased competition encouraged as a result of removing barriers to existing markets. For this reason, operating authorities issued by the ICC, which existing bus operators had acquired over the last 50 years, have been rendered valueless. For many bus companies, the operating authorities they held were the major assets on their balance sheets. The inherent value of such operating rights was recognized in October, 1979 by the ICC's Office of Policy and Analysis. In a study entitled, "The Value of Motor Carrier Operating Rights", the ICC clearly recognized an active market-place for operating rights which existed under ICC supervision and with its consent. While prices varied according to specific rights bought and sold, the study indicated that operating rights were a very real asset to a carrier, functioning much as tangible assets do to other industries. That is, operating rights were included in the value of an enterprise and were a source of collateral for borrowing.

2/ Economic Recovery Tax Act of 1981, Pub. L. No. 97-34 § 266, 95 Stat 265-266 (1981)

Relying on the rules in existence prior to the 1982 Act, companies made substantial capital investment in such operating rights generally through purchase from other owners. These operating rights were listed as intangible assets on the balance sheet of the operator.

The sudden diminution in value of these operating authorities brought about by the 1982 legislation has had a negative impact on the balance sheet of the holders. The reduction in the overall net worth of all companies holding operating authorities has come at a particularly bad time since the industry is attempting to upgrade its fleet through the acquisition of more fuel efficient buses. With the average operator owning between four and six buses and each bus costing approximately $145,000 it can easily be seen that the ability to borrow is essential to the well-being of individual operators. The severe reduction in net worth resulting from the reduction in value of operating authorities is therefore a major problem for our industry.

In addition, with the reduction in book value brought about the the 1982 legislation, some operators may be the target of acquisition attempts by other carriers or other industries seeking to acquiure a transportation subsidiary. Mr. Chairman, I hope you would agree that it is important to correct the unanticipated results of bus deregulation and to ensure the continued viability and independence of the small entrepreneur.

Having suffered a severe loss in the value of operating rights, the members of the American Bus Association are unanimous in their support for the relief granted in S.1814. In addition, I should mention that a similar bill, H.R.3284 has been introduced by Congressman Ed Jenkins, a member of the House Ways and Means Committee. The situation of the inter-city bus industry following the enactment of the 1982 Bus Deregulation Act is similar to that of a business loss. Operators currently are in possession of an asset which is worthless, which has no market value and which grants them rights that are no longer enforceable. The Internal Revenue Code at § 165 and other sections, takes cognizance of the fact that tax relief should be granted in the case of expropriation, casualty, acts of God, and business related losses. In fact, the Congress has recognized several situations in the past where tax relief was deemed appropriate as a result of the consequences of federal legislation. For example, § 1071 of the Internal Revenue Code provides a special non-recognition provision concerning the sale or exchange of property pursuant to a change of policy or a new policy of the Federal Communications Commission. Similarly, § 1081 of the Internal Revenue Code provides for non-recongition of gain in an exchange or distribution in obedience to orders of the Securities and Exchange Commission. In addition, § 1101 - 1103 of the Internal Revenue Code grant specific relief to persons impacted by the bank holding company legislation which was enacted in 1956, 1966 and 1970. We feel therefore that amortization over 60 months of the adjusted book value of operating rights is in keeping with the spirit and policy of the tax law. Moreover, passage of this legislation would extend to the bus industry to same treatment afforded the trucking industry in 1981 following its earlier deregulation.

With regard to the legislative history of the Bus Regulatory Reform Act of 1982, it is significant to note that § 20 of the Act provides for relief from tax discrimination as between the bus and trucking industry. The conference report on the Act (Rept. No. 97-780) at page 55, states that, "This provision makes current law which prohibits the assessment, levying or collecting of taxes on motor carrier property in a manner different from that of other commercial and industrial property applicable to motor carriers of passengers. The provision thus makes the law uniform for motor carriers of passengers and motor carriers of property. The prohibition applies to taxes on real or personal property, general sales taxes or other levies that are part of the general tax structure applicable to commercial activity. It does not apply to highway-user taxes."[3] This language clearly indicates that the intent of the legislation was to treat carriers of passengers in the same manner as carriers of property for tax purposes. It is the position of the American Bus Association that this language specifically identifies the need for the legislation introduced by the Subcommittee Chairman and in favor of which we are testifying here today.

Passage of this legislation would also clarify the confusion which exists in the eyes of bus owners and operators with regard to the treatment of such operating rights for tax purposes. Under generally accepted principles of accounting in effect prior to the enactment of the truck deregulation bill of 1980, operating rights acquired after 1970 had been amortized generally over a period not to exceed 40 years. The ICC did not permit amortization or disposition of carrying costs or operating rights unless there had been impairment or diminution of value. However, with the passage of the Motor Carrier Act of 1980, the ICC Bureau of Accounts approved the issuance of Accounting Series Circular No. 188, Accounting for Intangible Assets. The

---

3/ H.R. Rep. No. 780, 97th Cong., 2nd Sess. 55 (1982)

ICC changed its accounting to conform its practices with the new generally accepted principles of accounting which require an immediate, one-time deduction for book purposes, because such legislative actions and recent Commission decisions impaired or diminished the market value of carrier operating rights.

Conversely, the relief granted to the trucking industry in the ERTA of 1981, while offering general guidance to bus operators, is specifically limited to motor common or contract carriers of property who held such operating authorities on July 1, 1980. Clearly, motor common or contract carriers of passengers who held operating authorities on November 19, 1982 (the date of enactment of the Bus Regulation of 1982) do not fall within these legislative parameters. As a result there is clear confusion within our industry as to how these operating authorities which are now worthless should be treated for tax and accounting purposes. A legislative clarification by the Congress would bring certainty to our industry and eliminate the need for significant expenditures for legal and accounting assistance.

Mr. Chairman, in addition to the uncertainty concerning the proper tax treatment of operating rights following the 1982 legislation, there is another pressing reason why this legislation should be enacted this year. In addition to the need for a legislative solution as a matter of fairness and equity, the interests of sound tax administration require the prompt enactment of this legislation. As indicated, the Bus Deregulation Act was passed in 1982, this is the first full taxable year in which the issue of how these operating rights should be treated for tax purposes will be addressed by the thousands of bus owners and operators across the United States. If this legislation were postponed until 1984 or even 1985, it could result in the filing of thousands of amended returns with the Internal Revenue Service. Being mindful of the burdens under which that agency currently functions, it would be unfortunate to bring about an additional burden in the form of amended returns from bus owners and operators. From the perspective of the membership of the ABA, it is also an inconvenience and expense which we would hope to be spared if possible. In addition, if there is a significant time gap between the actual reduction in value of operating authorities and the granting of tax relief, the negative impact on the financial position of individual companies will be exacerbated. It is for this reason, that we view the passage of S.1814 as a natural and local concomitant to the 1982 Bus Regulatory Reform Act.

The comparative ease with which operating authorities can be secured from the ICC in the wake of deregulation is having a significant competitive impact on some of our smaller established carriers which I would like to share with the Committee. (In fact, the ICC reports that as of last Wednesday, September 20, it had processed 1,436 applications for operating authorities since the effective date of deregulation). The typical situation concerns a small carrier which has borrowed heavily in order to purhcase operating authorities prior to 1982. Following deregulation, such a company's net worth dropped precipitously, with the drop in value of the operating rights. Potential competitors to the established operator, who have secured their operating authorities at no cost from the ICC, and which have little or no debt, are in a much stronger borrowing posture than the established operator. The new competitor because of a greater ability to borrow and because of little or no debt service obligation, can competitively drive out of business the older more established operator. We are seeing this phenomenon fairly frequently. Its cause is the rapid devaluation of operating rights brought about by the 1982 legislation. Enactment of prompt tax relief, while not making the established operators completely whole, would be a major step toward stabilizing the financial posture of these carriers.

On behalf of the members of the American Bus Association, I wish to thank the Chairman for the position he has taken with regard to this issue, and I will attempt to respond to any questions which the Subcommittee members may wish to pose.

Senator **Packwood**. Mr. Murphy, let me ask you this, or perhaps I should address it to Mr. Frulla:

Truck dereg and bus dereg are statutory. The freight forwarders dereg, as I recall, was more an administrative action of the ICC in the mid-1970's, was it not?

Mr. **Frulla**. That is true, sir.

Senator **Packwood**. Now, I know of no one in the bus industry that wants to go back to regulation. The trucking industry is probably split; but I find that many of those who were once opposed are coming around and accepting it. Are the freight forwarders fully behind deregulation, and would they be willing to have it made statutory and have no desire to go back to it?

Mr. **Frulla**. I believe so. Speaking for myself, Senator, yes, we are. But I would have to poll our industry first and ask them and get their opinions. But yes, I think if the deregulation comes to all modes we would support it completely. But we would not want to be one of the first ones out in dereg, completly deregulated.

Senator **Packwood**. Well, when did the ICC start deregulating you?

Mr. **Frulla**. Well, they started back in 1979, I believe.

Mr. **Murphy**. I think it's really 1978, Senator.

Mr. **Frulla**. Seventy-seven or seventy-eight, Senator.

Senator **Packwood**. What I want to make sure of is that you are included in writing off your certificates, because you are only deregulated administratively. I don't want the ICC coming back 3 or 4 years hence and regulating you and making whatever certificates you have written off valuable again, and having to try to undo the action that we have granted from a tax standpoint.

And it would also be unfair if we allowed you to write them off and then you went back to the ICC and pleaded for reregulation.

Mr. **Frulla**. Oh, no. We would not do that.

Mr. **Sherlock**. Senator, we do not want to change the rules.

Mr. **Frulla**. No, we would not do that, sir.

Senator **Packwood**. All right; that's what I wanted to make sure of.

Senator Danforth.

Senator **Danforth**. No questions.

Senator **Packwood**. If there are no other questions, gentlemen, thank you very, very much for coming.

Mr. **Frulla**. Thank you.

Mr. **Murphy**. Thank you, sir.

Senator **Packwood**. Now let's move on to S. 1815, and we have Mr. Philip Iglehart. I will also place in the record, after Mr. Iglehart's testimony, a letter from the National Association of Independent Colleges and Universities supporting S. 1815. Go right ahead, sir.

[The letter follows:]

**National Association
of Independent
Colleges and Universities**

Suite 503
1717 Massachusetts Avenue N.W
Washington D.C. 20036
202/387/7623

September 23, 1983

Senator Robert Packwood
SR-173 Senate Russell Office Building
United States Senate
Washington, D.C. 20510

Dear Senator Packwood:

On behalf of the National Association of Independent Colleges and Universities and the American Council on Education, which together represent over 2000 public and independent colleges and universities across the country, I would like to express our support for S. 1815. As we understand the legislation, colleges and universities would, under your bill, be afforded the opportunity to pool investments with pension plans and other 501(c)(3) organizations. In addition, the bill would allow colleges the opportunity to invest in debt-financed real property without incurring unrelated business income tax. The higher education community is appreciative of your continued leadership role in supporting colleges and universities. This bill is a further indication of that support.

The provisions of the bill are very favorable toward college and university investments. As educational institutions are being forced to rely increasingly on their own resources, debt-financed real estate investments are becoming even more important as a source of greater investment yield. As you say in your floor introduction of the legislation, "diversification is made easier if several charities and pension funds are permitted to share in the ownership of a corporation... diversification allows a sounder investment mix." Such diversification of investments between and among tax-exempts could prove to be extremely helpful to colleges and universities. In addition to allowing joint ventures among tax-exempt entities, we suggest an extension of the provision which would allow joint ventures between taxable and tax-exempt organizations. This extension would allow for even further diversification of investments.

S. 1815 would also exempt from taxation any income received from debt-financed real estate, if the entity involved is a 501(c)(24) organization. Colleges and universities would, therefore, be given the same investment opportunities as are currently afforded pension trusts.

In addition, we urge that you consider including in subparagraph (C) of proposed Section 501(c)(24) as item (v), "any organization described in paragraph (4) or (6), which is organized and operated for the benefit of or to perform the functions of or to carry out the purposes of one or more operating educational institutions described in IRC Section 170(b)(1)(A)(ii) which is controlled by such operating educational institutions." This will make it possible for a cooperative service organization of operating educational institutions, such as the Common Fund, which is exempt from Federal taxation under IRC Section 501(f), to provide investment services not only to operating educational institutions but also associations of operating educational institutions which are exempt from income tax under IRC Section 501(a).

The Common Fund has made it possible for colleges and universities, particularly those with small endowments, to have as a means of investing through an exempt organization which is tailored to their needs. There seems no reason why tax-exempt associations of colleges and universities should not be allowed to invest through an entity like the Common Fund, which services its member colleges, universities, and schools. We would note that the number of such entities with funds to so invest is limited and the amounts to be invested small. There is, of course, no effect on the revenue effect because the income is not taxable in any event. (See attached statement with respect to the Common Fund.)

The bill is generally a good one, of which we are very supportive. We ask that this letter be made a part of the record of the September 26 hearing before the Subcommittee on Taxation and Debt Management. We also ask that we be allowed to submit a statement at a later date, after we have had the opportunity to evaluate the impact of the legislation on higher education institutions. We thank you once again for introducing this legislation and we would be happy to assist you in enactment of this important legislation.

Sincerely,

Christine Topping Milliken
Vice President and General
Counsel, NAICU

Sheldon Elliot Steinbach
General Counsel, ACE

Attachment

The Common Fund

1261 Post Road
P.O. Box 940
Fairfield, Connecticut 06430
(203) 254-1211

August 3, 1983

STATEMENT IN SUPPORT OF PROPOSED LEGISLATION

The Common Fund was established July 1, 1972 as a non-profit membership corporation. Its purpose is to pool endowment and other funds of its member educational institutions and arrange for professional investment management. (See background summary attached.) By combining the smaller funds of many institutions into large funds it can attract the best professional investment firms and achieve economies of scale.

Over the past twelve years The Common Fund has established four investment pools; for common stocks, bonds, money market securities and international investments. The attached chart shows the organization and management structure of these four investment programs. Also attached is a list of the more than 400 colleges, universities and independent schools that have become members of The Common Fund over the past twelve years. Investment results have been excellent, as shown in the chart and table attached.

Section 501(f) was added to the Internal Revenue Code in June 1974 to provide a basis for the permanent tax-exempt status of The Common Fund. Prior to that time The Common Fund had limited exemption based on the fact that the Ford Foundation had paid the start-up costs involved. The 1974 code provision limited membership to certain educational institutions described in Section 170 of the Code. The purpose of the proposed amendment is to extend eligibility to a variety of non-profit educational associations that were created and are controlled by colleges, universities and independent schools and operated exclusively for their benefit or to carry out their functions. There are organizations such as the American Council on Education, the Association of Governing Boards of Colleges and Universities, and the National Association of Independent Colleges and Universities. There are probably no more than 100 such organizations, and all deal with very limited amounts of money. Many could benefit from the pooling of their investments in The Common Fund, and thus, more effectively purchase investment management services provided by taxable suppliers. There is no tax revenue implication to the proposed legislation because all these organizations are already exempt and pay no taxes on investment income.

Investment Management For Educational Institutions

STATEMENT OF PHILIP IGLEHART, PRINCIPAL, RREEF FUNDS, SAN FRANCISCO, CALIF.

Mr. INGLEHART. Thank you.

Mr. Chairman and Senator Danforth: I am pleased to have this opportunity to present the views of the RREEF Funds in full support of S. 1815, which would exempt from taxations corporations that acquire and manage real property for certain other tax-exempt organizations and would provide for these corporations the same exemption from the tax on unrelated business income derived from debt financed property as now enjoyed by certain other exempt organizations.

The RREEF Funds are the largest group of closed-end tax-exempt real estate investment funds in the United States. Since 1975 the RREEF Funds have provided an opportunity for exempt organizations, principally pension funds and government plans, to invest in a series of professionally managed, comingled, closed-end real estate investment funds.

At this time the RREEF Funds have over $1.5 billion under management for exempt organizations, earning a return on investment which enables these organizations to carry out their exempt purposes.

Although admittedly this bill is in our interests as sponsors and managers of tax-exempt funds, we recognize that our interests and the interests of those similar to ourselves is not of dominant public policy concern.

Senator PACKWOOD. Let me interrupt you just a moment, Mr. Iglehart, because if you read this entire statement it is going to take you longer than your allotted time.

Mr. IGLEHART. OK.

Senator PACKWOOD. If you could abbreviate it, we would appreciate it.

Mr. IGLEHART. All right.

Senator PACKWOOD. All of the statements are in the record in their entirety.

Mr. IGLEHART. Yes. Thank you.

The best way to express what we are about here is that we would like to eliminate many of the inconsistencies that exist between various entities in which tax-exempt organizations can invest in real estate. We would like to unify under one roof, so to speak, the many freedoms which we have been able to secure in these different entities, which have been granted under various circumstances and at various times in the past.

Thank you.

[The prepared statement of Philip C. Iglehart follows:]

STATEMENT OF
PHILIP C. IGLEHART
PRINCIPAL, RREEF FUNDS
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to present the views of the RREEF Funds in full support of S.1815, which would exempt from taxation corporations that acquire and manage real property for certain other tax-exempt organizations and would provide for these corporations the same exemption from the tax on unrelated business income derived from debt financed property as now enjoyed by certain other exempt organizations.

The RREEF Funds are the largest group of closed-end, tax-exempt real estate investment funds in the United States. Since 1975, the RREEF Funds have provided an opportunity for exempt organizations, principally pension funds and government plans, to invest in a series of professionally managed, commingled, closed-end real estate investment funds. At this time, the RREEF Funds have over $1.5 billion under management for exempt organizations, earning a return on investment which enables these organizations to carry out their exempt purposes.

Although admittedly this bill is in our own interest as sponsors and managers of tax-exempt funds, we recognize that our interest -- and the interest of those similar to ourselves -- is not of dominant public policy concern. What is, however, of such concern is that tax-exempt institutions with equally worthy missions be treated fairly, in a nondiscriminatory fashion, and that those institutions be permitted easily to diversify their investments so that they can minimize the risk of asset shrinkage which so plagued these institutions in the 70's.

Present law not only treats tax-exempt institutions, with equally compelling claims for government policy approval, discriminatorily, but also it does so in an arbitrary and capricious fashion amounting to a crazy quilt pattern of regulation that extends the old adage -- the life of the law is experience rather than logic -- to new indefensible ground.

Mr. Chairman, we come before your committee to plead for this bill, S.1815, because it would neatly correct present inequities. Should it pass, we believe there would be no revenue loss to the Treasury; indeed efforts we have seen to conjur up a revenue loss seem more metaphysical than economic.

Briefly, as we understand the bill, it would add a new section, 501(c)(24), to the Internal Revenue Code that would provide exemption from taxation for a corporation that has as shareholders only other tax-exempt organizations of the type that generally invest in real property and that limits its (the corporation's) activities to the acquisition and management of real property. Different kinds of exempt organizations, for example a pension trust, a public charity and a university, could be shareholders in the same 501(c)(24) corporation, thereby enabling those organizations to diversify their real estate investments in a common vehicle. Secondly, the bill would extend to these 501(c)(24) corporations the exemption from the unrelated business income tax on debt financed property currently extended to pension trusts and government plans, thereby correcting the unfair, treatment of investments by other exempt organizations, particularly educational institutions and foundations.

Background

Before 1977, Section 501(c)(2) corporations were useful vehicles for a group of tax-exempt organizations to invest in real property. Section 501(c)(2) exempts:

> Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt under this section.

Both tax-exempt entities such as organizations described in Sections 501(c) and 501(d) and pension plans described in Section 401(a) were at that time eligible to invest in 501(c)(2) corporations. Tax-exempt entities could invest in such a corporation simply by purchasing its shares of stock, an obviously convenient and comfortable mode of investment for tax-exempt institutions. Since multiple tax-exempt entities of different types (e.g., pension plans and charitable foundations) could purchase shares in the same corporation, this device afforded tax-exempt entities an opportunity to diversify their investment portfolios by investing in real property. Utilization of a Section 501(c)(2) corporation was approved in at least two instances by the National Office of the Internal Revenue Service.

In 1977, however, the IRS reversed its earlier position and concluded that a Section 501(c)(2) corporation could not be owned by "unrelated" tax-exempt entities. Moreover, the IRS stated that a Section 501(c)(2) corporation could not be sponsored by investment advisers, (too "commercial") but rather had to be established by a tax-exempt entity itself.

Another vehicle through which tax-exempt organizations have invested in real property is the group trust -- an entity described nowhere in the Internal Revenue Code, but "created" in Internal Revenue Code Ruling 56-267, which sets forth the requirement for the group trust. In effect, a group trust is a pension trust described in Section 401(a) which can have as beneficiaries only other pension trusts. Group trusts are exempt from federal income taxation pursuant to the provisions of Revenue Ruling 81-100. The IRS did not and does not express any concern that the group trust, as opposed to a 501(c)(2) corporation, would have multiple beneficiaries, or that investment in it would be commercially solicited. Indeed, the National Office also issued a ruling extending tax-exempt status to a Section 501(c)(2) corporation wholly-owned by a group trust, on the grounds that ownership of the corporation by the group trust avoided the IRS's two stated concerns, *i.e.* the corporation would not have multiple parents and shares in the corporation would not be marketed.

Unfortunately, there are two primary shortcomings to the group trust as an investment vehicle for tax-exempt entities. The first is the limitation on eligible investors in the group trust. Tax-exempt foundations, endowments, and similar exempt organizations cannot currently invest in group trusts. Secondly, under the laws of many states the owners of the trust may be personally liable for the obligations of the trust and limited liability is of particular importance to the typical tax-exempt institutions.

Another inconsistency concerning these investment vehicles centers on transactions involving debt-financed property. In 1980, Congress added Section 514(c)(9) to the Code, permitting a "qualified trust," which is any trust described in Section 401(a) (*i.e.*, pension funds including group trusts, to acquire real estate subject to leverage without owing any unrelated business income tax. Previously, a portion of the income generated by leveraged property had been taxable. This section solved the problem faced by group trusts when they acquired property subject to existing debt at favorable rates or debt which could not be paid off without significant prepayment penalty. The benefits of Section 514(c)(9), however, apply to group trusts but not to a Section 501(c)(2) subsidiary. Thus, it is presently impossible to achieve simultaneously the protection of limited liability and the treatment granted by Section 514(c)(9).

Enactment of S.1815 is necessary to resolve these inconsistencies in present law and to provide an opportunity for other exempt organizations, predominantly smaller than pension funds, to make prudent real estate investments. Only through enactment of S.1815 can this purpose be achieved. Amounts which a smaller organization can afford to invest would not enable it to make a prudent real estate investment unless its funds are combined with those of other organizations. Thus, unless these organizations can combine their investment with those of exempt organizations with larger amounts to invest, such as pension trusts, any real estate investment by these smaller organizations is difficult, and prudent diversification of that investment is impossible.

To facilitate these investments by smaller exempt organizations it is necessary not only to create a Section 501(c)(24) corporation, but also to extend to that corporation the exemption from the tax on unrelated business income from debt financed property.

It is simply unfair to discriminate against organizations such as public charities and educational institutions by denying them the tax treatment currently extended to other organizations such as pension trusts.

Such discrimination seems particularly inexplicable at a time when budget pressures force Federal and state governments and the American people to depend even more on these institutions. As the Chairman is aware, this committee has had hearings on other bills that address "unrelated business tax" discrimination questions. Since the Treasury opposed the 1980 legislation providing relief to pension plans they apparently continue to oppose extending the same relief to educational institutions and foundations. But the Congress is not going to repeal the 1980 law -- nor should it. It is time, therefore, for the government, as a whole, to cure the unjustified discrimination it has caused.

Moreover, if these smaller organizations are to be able to invest in real estate jointly with pension trusts and government plans, they must be treated equally for unrelated business income tax purposes in order to avoid a conflict of interest within a 501(c)(24) corporation. In other words if a "pass through" of tax treatment of income were to occur, so that some shareholders in the corporation (the pension trusts and government plans) were exempt from the unrelated business income tax, and the other shareholders were not exempt, then the shareholders would have conflicting interests whenever an opportunity arose to acquire a property with a pre-existing mortgage at a favorable rate.

This problem of conflicting interests would not be solved by creating separate funds for the shareholders not exempt from unrelated business income tax. Smaller exempt organizations, even if their investments were combined, would not generally be able to invest a large enough amount to achieve the necessary diversification. For example, the RREEF West Funds, investing in property in the western United States, generally invest a total of $75-80 million, all in projects which each have a price of $15 million or less. To achieve this kind of investment, it is necessary to combine investments of smaller exempt organizations with those of pension trusts and government plans. Furthermore, since the leading investment advisers, including RREEF, organize funds for pension trusts and government plans throughout the United States, these advisers could not assist a separate fund comprised of different kinds of exempt organizations because of the conflict of interest necessarily arising when the adviser had to decide whether to acquire a particular property for the fund of the pension trust and governmental plans, or the fund composed of other exempt organizations.

No currently existing investment vehicle satisfies the need which would be filled by S.1815. For example, the investment needs of exempt organizations cannot be satisfied by use of a limited partnership. In order to have a valid limited partnership, at least one investor would be forced to act as the general partner, subject to complete liability for partnership obligations which could not be limited to its investment in the partnership. Furthermore, if a corporation or investment adviser was to act as general partner, the standards set by the Internal Revenue Service for issuing a ruling as to the partnership's validity would require maintenance of a net worth and investment in the partnership of a size which is generally beyond the capabilities of any single investment adviser or exempt organization.

In recent years, the lack of any acceptable investment vehicle has forced RREEF to advise numerous organizations that RREEF could not assist them in making prudent real estate investments. These organizations include the Ford Foundation, the Rockerfeller Foundation, the Mellon Foundation, the J. Paul Getty Foundation, the Murdock Foundation of Oregon, and the Kamehameha Schools of Hawaii. We understand the need for this legislation has prompted support for S.1815 from the Association of Private Colleges and Universities and the Council on Foundations.

Because S.1815 corrects unfair treatment of smaller exempt organizations with regard to investments in real property, and because it corrects inconsistencies in the law which affect all exempt organizations, we join the Association of Private Colleges and Universities, and the Council on Foundations, in supporting S.1815.

* * *

This concludes my prepared remarks. I would be happy to answer your questions.

Mr. SILBERMAN. Mr. Chairman, may I also introduce myself?

Senator PACKWOOD. Yes, sir.

Mr. SILBERMAN. I am Lawrence Silberman, of the law firm of Morrison & Forster, representing RREEF.

It might be useful, since you have our testimony, if we might briefly refer to Treasury's points, Mr. Chairman. I don't know if that would be helpful, or not.

Senator PACKWOOD. I might introduce Mr. Silberman more fully. He hardly needs to introduce himself to this committee or this Congress. He is a former Ambassador to Yugoslavia, Deputy Attorney General, Under Secretary of Labor, and miscellaneous other positions in past administrations. I'm glad to have you with us.

Mr. SILBERMAN. There are a couple of points I would make with respect to the Treasury's testimony.

As I understood, the Treasury testimony basically made two points:

First, with respect to the unrelated income tax point, they say that they never liked it in the first place, Congress should never have extended the pensions, and since they didn't like it in the first place it shouldn't go any further; although they admit in their testimony that the distinction between pensions and other tax-exempt institutions, 501(c)(3), educational institutions and foundations, is as they say "tenuous."

Senator PACKWOOD. Yes. They would be happy if we repealed the pension exemption.

Mr. SILBERMAN. My view as a matter of public policy and my client's view as a matter of public policy, as the institution which operates and provides an investment vehicle for these institutions, is that there is no distinction between the two—the 501(c)3's on the one hand and the pensions on the other, and I think Treasury recognizes it.

So the Congress really has two choices: One, do you repeal the provision for the pensions, which Congress is never going to do? Or, two, do you rationalize it by giving the same benefits to the educational institutions and foundations?

And in a time of budget-cutting on the part of the Government, it seems almost absurd to suggest that the Government does not have an interest in increasing the corpus or allowing them to increase the corpus of educational institutions and foundations which perform much of the work that the Government otherwise would do if it had more funds. So that's No 1 with respect to the Treasury's objection to extending the unrelated business income tax beyond pensions to educational institutions and foundations and the corporations which 1815 would set up to do that.

The second point they made, or really the first one, is that—and I'll be very quick, Mr. Chairman—they don't like this corporation because they claim that the tax-exempt institutions ought to maintain control. And they use the 501(f) analogy.

What they don't pay attention to, if I may say so, respectfully, is that there is a big difference between real estate investment and investment in stocks and bonds; that when a tax-exempt institution wants to go into real estate investment on a diversified basis, the only way they can do it is with a professional operation, because they have two choices: either to go and buy the real estate themselves, or if they go on a diversified basis they have to go with somebody like RREEF who knows how to do that. And RREEF originally did it for such educational institutions as Harvard, Dartmouth—I must say, Mr. Danforth, they did not have Yale; but they would have if the IRS hadn't changed their position. But in any event, the fact of the matter is, the only way a tax-exempt institution can invest in real estate is with an organization like this.

And the Treasury doesn't object to the group trust, which is the present institution, and which is done by RREEF. And of course RREEF runs that. And indeed the tax-exempt institutions wouldn't invest with them if they didn't trust them, or anybody.

I think there is sort of a paternalistic notion about what tax-exempt institutions are on the part of the Treasury.

Senator PACKWOOD. I was intrigued that they don't object to the trust. And it would seem to me, if their fear is a for-profit advisory group, somehow unduly enriching themselves, it can be done as well with a trust as with a corporation.

Mr. SILBERMAN. You are precisely correct, Mr. Chairman. There is no distinction at all.

Senator PACKWOOD. Though I fail to grasp that point. I understand how anybody, I suppose, can somehow control an organization in an attempt to manipulate it to its immoral or illicit benefit. But my hunch would be that the not-for-profit organization itself might have officers that could try to do that, if that were there intention. And it would clearly be illegal, but that doesn't always stop everybody. But I don't understand the difference between the for-profit and the not-for-profit advisors, in essence.

Mr. SILBERMAN. Neither do I.

Senator PACKWOOD. Senator Danforth.

Senator DANFORTH. No questions.

Senator PACKWOOD. I think your point is well taken, and, Mr. Silberman, you are right, we are not going to repeal the exemption for pensions. You can picture the yell that would go up if we start down that road. So we promise with premise-A—that is not going to change.

Clearly, I think it is unfair competition, one. Two, the purposes that this bill is directed to are clearly in the public interest; Treasury doesn't even argue that in terms of who we are trying to benefit. And I will see what we can do to get it through.

Mr. SILBERMAN. Finally, just the one last point, there is no tax revenue loss.

Senator PACKWOOD. Thank you.

Gentleman, Mr. Iglehart, thank you for coming.

Mr. IGLEHART. Thank you, Senator.

Senator PACKWOOD. Now we will move on to S. 120, and we have a panel of Mr. Paul Cheremeta and James Gashel.

STATEMENT OF PAUL CHEREMETA, NATIONAL PRESIDENT, PARALYZED VETERANS OF AMERICA, WASHINGTON, D.C.

Mr. CHEREMETA. Thank you, Mr. Chairman.

My name is Paul Cheremeta. I am the national president of the Paralyzed Veterans of America. I would like to thank you for providing us with this opportunity to summarize our written statement.

At this point I would like to submit, with your permission, for the record a letter which lists the organizations who join PVA in supporting legislation to improve accessibility for the elderly and handicapped to privately owned places of commerce, recreation, housing, and employment.

Senator **Packwood**. It will be in the record, together with your statement in full.

Mr. **Cheremeta**. Thank you.

[The prepared statement of Paul Cheremeta and letters follow:]

PARALYZED
VETERANS
OF
AMERICA
CHARTERED BY THE CONGRESS OF THE UNITED STATES

STATEMENT OF PAUL CHEREMETA, NATIONAL PRESIDENT
PARALYZED VETERANS OF AMERICA
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE COMMITTEE ON FINANCE
CONCERNING
S. 120, REINSTATEMENT OF SECTION 190 OF THE INTERNAL REVENUE CODE
SEPTEMBER 26, 1983

Mr. Chairman and Members of the Subcommittee, on behalf of the members of Paralyzed Veterans of America and all handicapped, disabled, and elderly Americans, I would like to thank you for conducting this examination of S. 120 and ways to improve accessibility for the handicapped in privately-owned, publicly-used places of commerce. I am Paul Cheremeta, National President of PVA.

Accessibility for the handicapped in privately-owned places of commerce, recreation, housing, and employment has long been one of PVA's highest priorities. Consequently, we have dedicated considerable effort to examining

801 Eighteenth St., N.W., Washington, D.C. 20006 (202) USA-1300

ways to improve for the handicapped this basic right of ingress and egress in public places.

It is for this reason that PVA has endorsed the incentives created by Section 190 of the Internal Revenue Code to open publicly used places to the handicapped. This Section has consumed considerable efforts on the part of PVA in two ways: first, we have worked to make this now-expired section of the Code known to business persons. Second, we have dedicated great effort to maintaining its Congressional authorization as part of the Tax Code.

PVA and a wide variety of other disability rights organizations, therefore, greatly appreciate today's hearing by this Subcommittee aimed in part at examining accessibility for the handicapped and elderly. We are very pleased to comment on S. 120, a legislative proposal which would reinstate the provisions of Section 190 for two years.

PVA supports the beneficial intent behind S. 120; however, as will be discussed later, we would prefer a legislative proposal which addresses the dual problems that have become apparent as we have worked for accessibility. That is, one problem has been the size of the maximum allowable deduction. The other, and larger problem, has been the inability by groups such as ours to adequately publicize the existence of the deduction to members of the business community, due to the short-term authorizations of Section 190.

There has not been adequate time for making known such a deduction and for encouraging the millions of businesses to make use of it. This hurdle has been compounded by the short-term authorizations of Section 190 which have not provided businesses adequate lead time to respond, upon learning of the existence of the tax deduction.

Relationship Between Income Tax Deduction and Improved Accessibility

Quite briefly, Section 190, which was created in 1976, allowed businesses to make their facilities accessibile and to elect to deduct accessibility-related costs from taxable income. It was anticipated, therefore, that whenever publicly-used facilities were routinely renovated, those having the work done would make the changes necessary to accommodate the handicapped.

Tax laws combine with other social forces to affect the handicapped, and this fact is revealed quite clearly in housing. Consider an apartment complex where the owners desire to renovate it. The owners of that expensive venture reflect on alternatives as ways of making their apartments more attractive to the general population. Their goal is to make their apartments appealing to more potential tenants, or to those capable of paying higher rents.

To the able-bodied renter, garbage disposals, balconies, and improved landscaping are more likely to come to mind as being desirable than are ramps, bathroom grab bars, and widened doorways. It is easy to see, then, what the apartment building owners will do to upgrade their facility and to thereby appeal to the greatest number of people. It is also easy to see which group must search longer to find suitable housing.

Employment of the handicapped, like accessible housing, is an area of utmost concern to PVA. Perhaps the relationship between an income tax deduction such as that existed under Section 190 and employment of the handicapped can be illustrated by developments in the electronics industry.

PVA is conducting a survey on the use of Section 190, the cost of accessibility modifications, and employment of the handicapped. Preliminary findings from this endeavor will be discussed more in depth later. However, it is worth stating at this point that electronics manufacturers have made considerable strides in hiring the handicapped, and the industry should be acknowledged for its accomplishments.

In the case of an electronics manufacturer who desires to hire handicapped workers, the income tax deduction can have special value. For example, the potential employer first must make his facility accessible for ingress and egress; therefore, he would add close-in parking areas and ramps and would make rest rooms accessible. Then, he would make the work site accessible, which would include modifying workbenches or obtaining special drafting tables.

Items used in these industries are quite expensive, and the specialized ones required by some handicapped employees are even more costly. However, once these basic alterations are made and the items are purchased, the qualified handicapped person is ready to become a skilled employee.

An industrial rehabilitation counseling service from Forest Park, Illinois, which specializes in promoting the employment of industrially-injured individuals, recently wrote to PVA, stating that the income tax deduction has helped open many employment opportunities for its clients that otherwise would not have been available.

Places of recreation and commerce also have been opened to the handicapped and elderly through the existence of the income tax deduction that was available under Section 190. For example, in Boca Raton, Florida, a town of 60,000 people, the Mayor's Committee for Disabled Persons, in mid-1982, undertook making stores accessible to handicapped persons. Even though state law requires that any public building constructed after October 1975, is to be accessible, there of course remain many facilities that are exempt. This situation typifies that found in most communities throughout the country.

The Boca Raton Mayor's Committee and the local Chamber of Commerce publicized the tax deduction available under Section 190. Then, they and local merchants worked together harmoniously to make two shopping centers accessible to the handicapped.

A member of the Mayor's Committee informed PVA that Section 190 was instrumental in this effort in two ways. First, businesses utilized the income tax deduction. Second, it was effective in a hidden way: the income tax deduction was an effective inducement which led many of these businesses to make their facilities accessible. Later, upon completion of the projects, business persons learned that modifications had entailed far less expense than was anticipated.

In Suffolk County, New York, a similar project (aimed specifically at adding handicapped parking, needed ramps, and curb cuts) was successfully undertaken in late 1982 by the County Office of Handicapped Services, a group of disabled veterans, and local merchants. The result was that over 200 handicapped parking spaces were installed, along with appropriate curb cuts and/or ramps.

The approach used in Suffolk County was that the County Office of Handicapped Services first informed merchants of existing state law, effective January 1, 1982, that required accessible parking. Then the Office specified to merchants that it would prefer voluntary compliance with this law, rather than having to take undesirable actions for enforcement. Furthermore, in reinforcing its position, the Office cited similar county ordinances. Finally, in its information packet that was sent to merchants, there was an explanation of the income tax deduction available under Section 190.

In 1982, the Suffolk County Office of the Handicapped received a Community Program Award from the National Organization on Disability for its accomplishments, and in 1983 it received a small grant with which it is to continue publicizing the need for accessibility and creative ways it can be achieved.

The Director of this County Office wrote to PVA, stating that the available income tax deduction helped them exceed the accessibility standards set by local law: "Many owners of shopping facilities took advantage of this federal tax incentive to add ramps and curb cuts at their shopping facilities which were not required by law...Business persons were willing to cooperate in this project because part of the cost would be offset by the federal tax deduction."

Nassau County, New York, has likewise reported projects aimed at improving accessibility in places of commerce, and the Office of the County Executive reports a beneficial working relationship that arose between local government agencies, local business persons, and various groups (such as Kiwanis Clubs, Rotary Clubs, and Lions Clubs), as they have used the income tax deduction for removing architectural barriers.

The Nassau County project was very similar to that already reported from Suffolk County. The Nassau County Director of Services for the Physically Handicapped laments in one letter the expiration of Section 190 because, in its absence, there is "little or no 'business' leverage for local government offices like ours to create partnerships with the private sector in reducing these architectural and other barriers."

Congressional Actions Creating §190 and Efforts to Maintain It

At this time I would like to outline very briefly the history of Section 190 and to note the repeated efforts at preventing its expiration during the past several years. Understanding these events will help explain some of the recommendations PVA will make later in this testimony. More importantly, past events help illustrate, to a large degree, why Section 190 has not been as effective in the removal of architectural barriers as was intended.

The provisions of Section 190 were created only relatively recently, when they first appeared as Section 2122 of the Tax Reform Act of 1976. Except for a few provisions addressing the needs of the blind, Section 190 was the only statement in the Tax Code which directly benefitted the handicapped.

Senator Robert Dole, sponsor of Section 2122, recognized that the government must provide an incentive, such as an income tax deduction or credit, to induce business operators to bear a portion of accessibility-related costs.

Over the past seven years, disability rights organizations such as PVA have dedicated considerable effort to preserving and improving the provisions of the now-expired Section 190. As a result of this expressed concern, Senator Robert Dole introduced a bill in the 96th Congress (S. 1694) to increase the maximum allowable deduction from $25,000 to $50,000 and, very importantly, to make it a permanent part of the Code.

The reason for the proposed increase in the maximum allowable deduction was that many businesses had expressed an interest in using the tax deduction for the removal of architectural barriers, but had found that the existing deduction was insignificant compared to the expenditures they would have to incur in making large or multiple facilities accessible to the handicapped.

Furthermore, making Section 190 a permanent part of the Revenue Code was an effort to give groups such as PVA time in which to make the existence of Section 190 known to a larger portion of the business community and to convince businessmen that the deduction would be available when the renovations were completed. It was being discovered that most businesses had never heard of Section 190 and of the deduction available for the removal of architectural barriers and that the two-year limitation made use of the deduction sporadic at best.

Unfortunately, the Senate Committee on Finance, to which Senator Dole's bill was referred, failed to give this bill (S. 1694) significant attention.

Senator Dole's actions in mid-1979 were urgently needed, because the provisions of Section 190 were to have expired December 31, 1979. PVA, therefore, sought the support of the House Committee on Ways and Means. The Honorable Al Ullman, then Chairman of Ways and Means during the 96th Congress, did not agree to have the Committee conduct hearings to investigate the feasibility of expanding the provisions of Section 190 of the Tax Code. However, he rescued Section 190 from dying and secured a three-year extension of its provisions. This action was taken when an amendment was offered to a larger tax bill.

On January 5, 1981, the first day of the 97th Congress, Senator Dole, now Chairman of the Finance Committee, introduced a new bill which would have amended the Tax Code in the same manner as his earlier legislative proposal.

Time was quickly running out again, because the provisions of Section 190 were scheduled to expire on December 31, 1982, and two years is not much time in which to work for implementation of legislative issues that occupy relatively small positions, such as Section 190 does in the Revenue Code. Despite the efforts of PVA and other disability rights groups, the Senate

Committee on Finance was not able to conduct hearings on Section 190 during the 97th Congress.

Former Representative Don Bailey, a Member of the House Committee on Ways and Means, was very responsive to PVA's desire to see Section 190 made an effective tool for the removal of architectural barriers. Therefore, as time was becoming crucial, he introduced a bill (H.R. 6460) in 1982, one that would have made Section 190 a permanent part of the Tax Code and which would have increased the maximum allowable deduction to $100,000. This proposal, which was identical to that by Senator Dole in the Senate, attracted 36 co-sponsors, but the Ways and Means Committee, involved with larger revenue issues during difficult economic times, failed to conduct hearings.

Late in the 97th Congress, when it became apparent that Section 190 was about to expire, the Honorable Fortney H. Stark, Chairman of the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, introduced H.R. 7157, a bill that would have extended the authorization of Section 190 for two additional years. However, during the lame duck session of Congress last year there was no suitable opportunity for consideration of a variety of smaller provisions of the Tax Code, including Section 190.

During the closing days of the 97th Congress, the Honorable Howell Heflin introduced on the floor of the Senate an amendment to the Surface Transportation Act of 1982. This amendment increased the allowable deduction available under Section 190 to $100,000 and made Section 190 a permanent part of the Code. However, House Conferees did not accept this amendment because, it is reported, there had not been hearings to examine the provisions of this proposal.

Despite these efforts by a variety of disability rights organizations and a sizable number of distinguished Members of the Senate and House, Section 190 expired on December 31, 1982.

Current Legislative Efforts to Reinstate Section 190

Reinstatement and/or expansion of the provisions of Section 190 have received considerable Congressional attention in the 98th Congress. In the Senate, for example, S. 111 by Senator Orrin Hatch would increase the maximum allowable deduction to $50,000, and would make the provisions of Section 190 permanent. Furthermore, S. 120 by Senator Robert Dole would extend the original maximum $25,000 deduction for two years.

Actions in the House are likely to be of concern to this Subcommittee because of the variety of bills introduced in the House that would reinstate Section 190 of the Code. Chronologically, there is H.R. 267 by the Honorable James H. Quillen. This bill would increase the maximum allowable deduction to $100,000 and would make Section 190 permanent.

The Honorable Edward R. Roybal has introduced H.R. 669, which would make permanent the provision of the $25,000 deduction.

Representative Fortney Stark has introduced H.R. 901, which he discusses in the June 30, 1983, Congressional Record. In this statement he actively seeks

Congressional support for reauthorization of Section 190. Regrettably, however, his bill would extend for only two years the availability of the $25,000 deduction.

Representatives Norman F. Lent and Raymond J. McGrath have introduced H.R. 988, which would increase the maximum allowable deduction to $100,000 and would make Section 190 permanent.

Finally, Representatives William Hill Boner, Harold Ford, and Robert Matsui have introduced H.R. 1016. This bill, which PVA and over a dozen other disability rights organizations strongly support, would increase the maximum allowable deduction to $100,000 and would make Section 190 a permanent provision of the Revenue Code. H.R. 1016 has approximately 100 co-sponsors.

Basically, then, there are three maximum allowable deductions under Congressional consideration at this time ($25,000; $50,000; and $100,000). Furthermore, all the relevant legislative proposals would either make Section 190 a permanent part of the Code or would reauthorize it for two years.

The Joint Committee on Taxation estimates that for the maximum allowable deduction to have the same impact today as it did in 1976, it would need to be increased to $48,000. Furthermore, the Joint Committee, in early 1983, made the following revenue cost estimates for the three maximum allowable deductions under consideration:

Joint Committee on Taxation Revenue Cost Estimates

Estimated Revenue Losses*

Option Under Consideration	Fiscal Years--Millions of Dollars 1983	1984	1985	1986	1987
1. Make permanent Section 190 and maintain limit at $25,000	-7	-13	-13	-12	-11
2. Make permanent Section 190 and increase limit to $50,000	-13	-25	-23	-22	-22
3. Make permanent Section 190 and increase limit to $100,000	-40	-39	-38	-37	-37

*In 1976, it was predicted that revenue losses for the $25,000 deduction would be $10 million annually. Considering the effects of inflation and the only slightly larger estimates made in early 1983, it appears that the provisions of Section 190 may not have been utilized quite as widely as was anticipated, since the 1983 projections are only slightly greater than the ones made in 1976.

Four Studies on Section 190, Accessibility Costs, and Employment of the Handicapped

A. PVA Study

PVA is currently conducting a study of accessibility costs and the use by businesses of the tax deduction allowed under Section 190. This information is being sought from approximately 2,800 randomly selected businesses. Responses to questionnaires are beginning to arrive, but the response has been slow and of mixed value, in that many questionnaires are being returned incomplete. It appears, therefore, that follow-up questionnaires to respondents will be required in order to ascertain specific accessibility costs.

Some preliminary observations, based on responses by businesses, can be summarized, however, from the limited responses available. First, the vast majority of businesses did not know of the existence of the income tax deduction available under Section 190 of the Revenue Code.

Second, smaller businesses that are concerned enough to modify existing facilities in order to make them accessible to the handicapped are also the ones most likely to employ the handicapped and disabled.

Third, most businesses that have made expenditures expressly to enhance accessibility for the handicapped and elderly have incurred expenses of less than $30,000.

Fourth, most smaller businesses that have inaccessible facilities and which do not intend to make them accessible cited expense as the reason for their inaction. Generally, these estimated costs exceeded $40,000.

Fifth, most larger businesses that have inaccessible facilities and which do not intend to make them accessible cited the large number of facilities as the reason for their inaction.

Sixth, both larger businesses and smaller ones that have more modern facilities do not require the deduction because their facilities are built to be accessible when constructed.

Based on these six observations, it is apparent that smaller businesses would be the primary users of any available income tax deduction aimed at removing architectural barriers, given the probable size of the deduction. Furthermore, it is evident that those businesses which have used or will utilize the deduction for the removal of architectural barriers are the ones that will most likely hire handicapped workers. This factor indicates that the income tax deduction can thereby increase the number of employers of the handicapped and can diversify the types of employment available to the handicapped.

Following are fourteen examples of responses to PVA's survey, which should help explain the costs of accessibility and the nature of modifications that are needed, in addition to indicating that accessibility results, quite often, in the employment of the handicapped. Please note: these responses were more detailed than were most, which indicates an added awareness of the needs of the handicapped by these employers. These employers were atypical in their awareness of the deduction available under Section 190 of the Revenue Code.

1. Electronics manufacturer in New Jersey
   Spent $23,000 making facility accessible
   Labor force of 1,600 employees, 25 of whom are handicapped
   Used IRC 190 deduction

2. Electronics manufacturer in Ft. Lauderdale, Florida
   Spent $44,600 making facility accessible
   Employs unspecified number of handicapped
   Did not know of IRC 190

3. Insurance company in Illinois
   Spent $20,000 making facility accessible (Modifications included restroom alteration, grading and ramping parking lot, and lowering water fountains)
   Employs 6 handicapped persons
   Used IRC 190 deduction

4. Publisher in California
   Spent $5,500 to make restroom modifications and to add a ramp

Employs "several" handicapped persons out of labor force of 600 employees
Did not know of IRC 190

5. Health products manufacturer in New York
Spent $10,000 in two facilities
Did not know of IRC 190

6. Manufacturer of automatic-opening doors in North Carolina
Spent $5,000 for accessibility
Did not know of IRC 190

7. Bank in Texas
Made most of its 61 branches accessible
Used IRC 190 to its maximum limit

8. Medical supply company in Maryland
Spent $1,000 to make restroom accessible
Employs 1 handicapped person out of labor force of 23 employees
Did not know of IRC 190

9. Electric equipment manufacturer in New Jersey
Spent $35,000 to make two facilities accessible (elevator in one, ramp in other)
Employs 2 handicapped in labor force of 80 employees
Did not know of IRC 190

10. Camera manufacturer in Massachusetts
Spent between $5,000 and $20,000 per each of 5 facilities
Employs 100 handicapped persons in labor force of 10,000 employees
Did not use IRC 190

11. Electronic equipment manufacturer in Massachusetts
Spent approximately $65,000 making one facility accessible
Employs 340 handicapped persons in labor force of 6,800 employees
Used the deduction available under IRC 190

12. Health-care equipment manufacturer in Illinois
Spent $5,000 making facility accessible
Employs 2 handicapped persons in labor force of 5 employees
Did not know of IRC 190

13. Health-care equipment manufacturer in New Jersey
Spent $3,000 making facility accessible
Employs 4 handicapped persons in labor force of 45 employees
Used the deduction available under IRC 190

14. Medical equipment sales company in Maryland
Spent $4,500 making facility accessible
Employs 7 handicapped persons in labor force of 19 employees
Did not know of IRC 190 deduction--plans to file amended return

Nearly all of the respondents who informed PVA that they have not made their facilities accessible, and that they do not employ the handicapped, indicated that they had never heard of the income tax deduction available under Section 190.

B. Department of Labor's Study of Government Contractors

In June 1982, the Department of Labor presented a two-volume study entitled "A Study of Accommodations Provided to Handicapped Employees by Federal Contractors." Volume I contains study findings, and Volume II contains ten case studies. This study was prepared by surveying 2,000 federal contractors.

Few reliable studies exist that examine the cost of accessibility in the numerous places PVA aims for Section 190 to be effective, the diverse places of commerce, recreation, housing, and employment that are found in all cities and towns throughout the nation. Therefore, this study of government contractors is, perhaps, the most reliable information that is available.

One discrepancy between the DOL study and PVA's must be stressed: that is, this study of government contractors deals, quite naturally, with larger employers and does not examine what is required in making the smaller facilities operated by sole proprietors and partnerships accessible. Furthermore, the employers studied in this examination have had considerable economic encouragement to make their facilities accessible to the handicapped, since hiring the handicapped is, in many cases, a prerequisite for receiving government contracts.

Section 503 of the Rehabilitation Act of 1973 requires that, for any contract in excess of $2,500, the party contracting with the United States shall not discriminate against the handicapped, and for those contractors with contracts in excess of $50,000 (or where there are 500 or more employees) there is to be a written affirmative action plan.

Without commenting on the effectiveness of Section 503 and its enforcement, PVA maintains that there has been some encouragement to those businesses examined in this DOL study to make their facilities accessible. On the other hand, the small business that does only very limited (or no) business with the federal government has virtually no incentive or requirement to make its places of operation accessible to the handicapped.

The value of this 1982 report by the Department of Labor in examining Section 190 is by analogy. Nonetheless, it is helpful.

On page 27 of Volume I appears Table 6, showing the most commonly needed accessibility features and employers' provision of those accommodations. These are generally the type of modifications needed by handicapped persons for ingress and egress to most places of business:

Accessibility Modifications

Type of Modification	Already Existed or Installed by Company		Not Needed, Infeasible, or No Response	
	Number	Percent	Number	Percent
Special parking, curb cuts	263	71.7%	104	28.3%
Ramped exterior entrance	233	63.5	134	36.5
Wide, easily opened doorways	246	67.0	121	33.0
Elevator	178	48.5	189	51.5
Audible/visible alarms	148	40.3	219	59.7
Braille or raised markings	48	13.1	319	86.9
Lowered public telephones	108	29.4	259	70.6
Lowered drinking fountains	112	30.5	255	69.5
Access to bathrooms	229	62.4	138	37.6
Access to personnel, other offices	245	66.8	122	33.2
Access to general use areas	226	61.6	141	38.4
Other modifications	32	8.7	335	91.3

The Department of Labor Study does not provide a per-item breakdown of the costs for making each of the accommodations noted above. However, Table 7, taken from page 30 of the study, gives some indication of these actual costs, just as it indicates, not surprisingly, that employers are less likely to make the more costly modifications.

Type of Accommodation by Total Cost of All Accommodations Provided to the Worker

Accommodation Type[b]	Percent of Accommodated Workers for Whom the Total Cost of All Accommodations Was:[c]										Total Accommodation Types and Costs Reported	
	Zero	$1-99	$100-499	$500-999	$1,000-1,999	$2,000-4,999	$5,000-9,999	$10,000-14,999	$15,000-19,000	$20,000 or more	Number[d]	Percent
Removed Barrier	10.8%	6.0%	30.1%	10.8%	13.3%	6.0%	2.4%	3.6%	6.0%	10.8%	83	5.6%
Adjusted Work Environment	15.9	15.9	36.4	0	11.4	11.4	6.8	2.3	0	0	44	3.0%
Adjsuted table, desk	13.8	18.4	32.2	9.2	9.2	9.2	2.3	1.1	1.1	3.4	87	5.9%
Other Rearrangement	26.7	13.3	25.0	8.3	11.7	5.0	3.3	3.3	0	3.3	60	4.0%
Relocated Worksite	58.8	5.9	11.8	0	11.8	11.8	0	0	0	0	17	1.1%
Modified Phone, Typewriter	23.3	51.2	9.3	9.3	4.7	2.3	0	0	0	0	43	2.9%
Microfilm, Dictaphone	8.3	8.3	16.7	0	16.7	8.3	8.3	0	8.3	25.0	12	0.8%
Other Special Equipment	10.0	30.0	21.4	11.4	8.6	7.1	4.3	4.3	1.4	1.4	70	4.7%
Job Transporation or Mobility	20.4	16.7	27.8	13.0	9.3	7.4	0	1.9	0	3.7	54	3.6%
Reassigned Tasks	43.4	20.9	8.5	11.6	3.9	5.4	2.3	1.6	0	2.3	129	8.7%
Modified Work Hours	52.6	5.1	20.5	5.1	7.7	5.1	0	2.6	0	1.3	78	5.2%
Other Modification of Work Procedure	49.6	20.9	12.2	4.3	5.2	4.3	.9	.9	0	1.7	115	7.7%
Assigned Aides, Reader	9.8	25.6	33.3	17.6	5.9	3.9	0	0	0	3.9	51	3.4%
Additional Training	39.3	20.2	21.3	10.1	2.2	2.2	1.1	1.1	0	2.2	89	6.0%
Oriented Coworkers, Supervisors	51.6	20.2	9.4	8.4	4.2	2.4	1.4	.7	.3	1.4	287	19.3%
Transferred to Another Job	57.7	21.9	5.1	3.6	5.8	3.6	0	1.5	0	.7	137	9.2%
Other Accommodation	57.3	10.7	13.7	6.9	4.6	6.1	.8	0	0	0	131	8.8%
Total											1487	100.0%

[a] Source: Company questionnaire responses.

[b] Where multiple accommodations were provided, they are listed separately.

[c] Percentages add across rows to approximately 100% (rounding errors).

[d] This is the number of accommodations of each type for which an associated cost was reported.

C. Small Business Administration Study

The Small Business Administration and Wright State University, in 1982, studied the effects of regulations on small business and federal contractors' compliance with Section 503 of the Rehabilitation Act. This study, "Regulation and Small Business Participation in the Federal Contract Market: The Effect of Section 503," is a detailed, 209-page report that was released in June 1982. Information for the report was gathered from questionnaires sent to 2,916 small business federal contractors, of which there were 726 usable responses. (page 4) Like the DOL study, it addresses a wide variety of issues of concern to those who deal in the specialized field of government contracts.

For our purposes, the study (page 116, Table 5-2) examines the types of handicaps found within the current work force:

Handicaps Found Within Current Work Force

Handicap	Percentage of Firms
Impaired hearing	40.4%
Heart or circulatory problems	39.8%
Impaired mobility	31.6%
Impaired vision	28.5%
Psychological/learning impairment	26.0%
Loss of limb(s)	19.0%
Other	14.6%
Impaired respiration	12.8%
Nervous system impairment	11.1%
More than one handicap	10.0%

It should be emphasized that the most common type of disability found in the work force is impaired hearing (40.4%), with impaired mobility (31.6%) following closely behind in representation.

One employer of the handicapped responded to PVA's questionnaire (in the PVA study noted above) and reported having spent $20,000 making his facility accessible to the mobility impaired. This respondent was aware of Section 190 and had used the income tax deduction. In his correspondence, the employer addressed the special needs of the deaf:

> We employ 6 deaf persons and the law does not provide the allowance for telephone communication devices for the deaf [TDD's]. With the use of these TDD's our employees function totally on their own. By providing employment we have removed at least three from drawing Social Security Disability....Laws requiring TDD's drastically need to be incorporated, as the "deaf" population is ignored in legislation.

One of these six employees is the company's comptroller, who "communicates with the bank by use of TDD, making investments, etc." "Another man functions effectively in accounting, also. Other persons operate word processing, typing, filing, and various office practices."

In short, this employer hires the handicapped in positions where there can be advancement for the individual employee, and he has used Section 190 effectively. This employer has, also, identified necessary changes that should be made in the regulations that accompany Section 190 of the Revenue Code.

The SBA study not only identifies the types of handicaps found in the work force, but it also attempts to ascertain the cost of accessibility among smaller contractors. This is a very difficult task, since only a small percentage have come within the requirements of Section 503. However, where there has been modification of facilities to make them accessible to the handicapped, "the mean cost per contractor is slightly more than $8000." (page 97) The following table, found at page 98 of the SBA study, illustrates more precisely the range of accessibility costs:

Cost of Changes to Physical Facility
to Comply with Federal Requirements

Approximate Cost	Percentage
$100 or less	1.4%
$101 to $500	1.6%
$501 to $1000	6.5%
$1001 to $2500	7.8%
$2501 to $5000	6.4%
More than $5000	76.7%
Total %	100.4%
Base n	58

D. Scientific American Report

The June 1983, Scientific American contains a detailed study entitled "Physical Disability and Public Policy." This fact-filled article contains numerous statistics dealing with the incidence of disability, local governmental units' responses to the requirements placed upon them, and a discussion of the demands placed on our national systems of health and human services. It also contains suggested future actions our society and government must take, if they are to address the needs of the disabled.

The article concludes with a discussion of architectural barriers and the limitations they place on handicapped and disabled persons who seek to enter the work force. The article, at page 49, states:

> One of the most powerful tools of policy implementation is the variety of economic incentives that government offers through the tax system and through government expenditures. The economic-incentives approach to policy implementation has not been widely tried with respect to architectural barriers. Some states have introduced modest tax deductions for the removal of such barriers. Until recently the Federal income-tax code allowed businesses a modest tax deduction of $25,000 in any given year. The statutory authority for the Federal tax deduction, however, expired last year. Although the size of the Federal tax write-off was far too small to be noticed by most large businesses, such cost-sharing schemes can help to foster compliance with governmentally sponsored accessibility standards.

This study maintains that for many potential employers of the handicapped the cost of accessibility is prohibitively great.

Recommendations and Conclusion

Mr. Chairman and Members of the Subcommittee, PVA appreciates the attention that each of you has given to amending the Revenue Code to provide inducements to businesses to remove architectural barriers that impede access of the handicapped and elderly to places of commerce, recreation, housing, and employment. The provisions of Section 190, which expired December 31, 1982, constituted the only measure in the Revenue Code that provided this much-needed incentive.

It appears from PVA's experience that the income tax deduction has been more attractive to smaller businesses than to larger ones, which is predictable, considering the limited nature of an income tax deduction and the size of the maximum allowable deduction that was available.

As has been pointed out, the income tax deduction for accessibility-related expenses provided a useful tool for making publicly-used places accessible in cases where businesses operated out of facilities that were not originally built to be accessible. This deduction has been helpful in that it provided business persons an alternative to adding accessibility costs to the base value of their facilities and then depreciating those costs over a number of years.

We regret that we have been unable to provide this Subcommittee with precise statistics on the usage of Section 190 in the removal of architectural barriers. In the past, when PVA has asked Congress to consider amending Section 190, we have met with a request that we provide concrete statistics showing the effectiveness of Section 190. There is a dearth of statistical information on Section 190 because the Internal Revenue Service cannot compile such data from tax records without an inordinate expenditure of man-hours and computer time.

Congress may, as part of reinstatement of Section 190, want to authorize the gathering of statistics on the relationship of the income tax deduction to the removal of architectural barriers. On May 6, 1983, the Honorable William Hill Boner, a strong advocate of reinstatement and expansion of the provisions of Section 190, requested a General Accounting Office study on the use and effectiveness of that Section. It was learned that use of Section 190, like many other provisions of the Revenue Code, is very difficult to document. GAO responded to Representative Boner:

> We are not readily able to address your request because the necessary data are not available. We were informed by several Federal and private sector officials that comprehensive historical data on the extent of the architectural and transportation barrier problem is unavailable for either the pre or post-tax expenditure enactment time frame.
>
> If the necessary data were available, an effective evaluation of section 190, as well as other tax expenditures provisions in general, would involve several steps.
>
> --First, to the extent feasible, data on the pre-tax expenditure extent of the problem should be collected and analyzed.
>
> --Second, trend data should be developed on the extent of the problem after the tax expenditure provision has been in effect. By comparing this data with the data collected under the first step, insights could be obtained as to whether the Code provision is achieving its intended effect.
>
> --Third, information should be developed on the characteristics of the users of the tax expenditures provision. Such data would show whether the Code provision is being used by the anticipated target population of taxpayers.
>
> --Fourth, through analysis of tax returns and related data, information should be developed on the nature and extent of administrative difficulties associated with the expenditures provision. This would involve both taxpayers and the affected governmental agencies, particularly the Internal Revenue Service.
>
> --Fifth, to the extent feasible, data should be developed on the issue of whether a tax expenditure is the most effective means to achieve the intent of Congress. For example, if one were to find that a particular tax expenditure provision was subject to extensive abuse by taxpayers, then an alternative direct grant program might prove less costly to the Federal Government than the tax expenditure approach.

As was shown earlier, the most that is projected in revenue losses surrounding reinstatement of Section 190 is $40 million annually. This projection, you will recall, was based on increasing the maximum allowable deduction from $25,000 to $100,000. Reinstatement of the previously-existing maximum allowable deduction of $25,000 would cost only between $7 and $13 million annually in revenue losses.

It is not clear whether these estimates include factoring in the amount of revenues that would be generated by expanded employment of the handicapped. Furthermore, it is not clear that this projection considered the savings that would result to the government when handicapped persons found employment and were no longer beneficiaries of federal programs.

Based upon the small revenue losses discussed above, and considering the important role Section 190 has played in improving accessibility for the handicapped and elderly in a number of communites, PVA feels very strongly that Section 190 should be reinstated in the Revenue Code.

Furthermore, we recognize, quite logically, that the larger the tax deduction, the more businesses to which it will appeal. This is true because those with multiple sites, large sites, or buildings that are difficult to modify, would have a greater inducement to remove architectural barriers.

PVA supports increasing the maximum allowable deduction to $100,000, a measure contained in a number of House bills.

We feel that increasing the maximum allowable deduction to $100,000 is quite reasonable, since to qualify for the income tax deduction businesses must take considerable action (they must make their facilities accessible in compliance with Internal Revenue Service Regulations). This requirement, we feel, has been a safeguard that has prevented abuses and which has ensured that the deduction was utilized only where some tangible good was achieved unlike those for which little or no overt action is necessary in order to qualify.

Secondly, and most importantly, PVA recognizes that if Section 190 is reinstated in the Revenue Code, its provisions should be authorized permanently or, at least, for a significant period of time such as ten years.

We have very good reason for asking that Section 190 be authorized permanently or for a significant length of time: all last year Congress was too busy addressing larger issues to give much consideration to maintaining the provisions of Section 190. Very obviously, the handicapped do not benefit when this, the only provision of the Tax Code aimed at removing architectural barriers, is allowed to expire.

Smaller businesses (the very ones most likely to utilize the deduction under Section 190) generally use the calendar year for their accounting purposes. Therefore, nearly all of 1983 has seen no incentive to them for removing barriers that impede millions of Americans.

Furthermore, disability rights organizations such as PVA are primarily the groups that will publicize the incentive to members of the business community. We have found individual business persons to be receptive to the removal of barriers, with financial incentives, but we have also discoverd that the existence of this deduction has not been widely publicized by the various business and commerical organizations, because it is such a minor provision of the Code and because it addresses a very specialized concern.

A clear example of the problem that has existed has been revealed to PVA by disability advocates who have worked in their local communities with individual business persons for the removal of barriers. At times they have had to seek the advice of Internal Revenue Service personnel in the field, as to the precise requirements for utilizing the deduction available under Section 190. IRS personnel generally had not familiarized themselves with the regulations that accompanied Section 190 of the Revenue Code because they saw it as both a small and a temporary provision.

Perhaps one of the most illustrative points concerning publicizing the provisions of Section 190 comes from the IRS itself. In 1982, the IRS provided handicapped taxpayers a pamphlet, "Tax Information for Handicapped and Disabled Individuals." This 32-page booklet (Number 907) contains an explanation of the deduction then-available under Section 190.

At the same time, there was another publication, "Tax Guide for Small Business" (Number 334), which is a 168-page guide. Even though small businesses make up the group most in need of educating on the tax deduction, this publication does not contain a discussion of the deduction for removal of architectural barriers. In short, the IRS was addressing the wrong audience, and it will take considerable time and effort by groups such as ours to have the business community made aware of the needs of the handicapped and to inform them that tax assistance is available.

PVA, in addressing the need for making Section 190 a permanent or long-term part of the Revenue Code, has met with some arguments from the staffs of the revenue committees against our position. One argument has been that periodic Congressional review helps publicize the tax deduction. This, it appears, is not accurate, since small businesses do not follow Congressional actions very directly.

Secondly, it has been argued that short-term authorizations provide an incentive for a surge of effort, in this case the removal of architectural barriers. This, we regret to say, has not been the case. Rather, Congress has very effectively addressed larger issues through the Tax Code and has had a decided effect on conditions when there have been crises. However, the existence of architectural barriers has been endemic, not epidemic. Therefore, there is not likely to be a sudden flood of attention to the problem among the citizenry.

When Congress has provided inducements for the sudden resolution of problems, there have generally been sizable economic incentives. There is little doubt that the removal of architectural barriers could be treated similarly, should Congress suddenly create an income tax credit for the full amounts expended in the removal of architectural barriers. Even though PVA would be pleased to see Congress provide such a moving incentive, it does not appear to be economically feasible or likely to happen.

In short, making the provisions of Section 190 temporary has not been an impetus to businesses to utilize the deduction, because the deduction is little-known, it is small, it requires considerable action before one qualifies, and it addresses an endemic problem that has received little public attention.

Mr. Chairman and Members of the Subcommittee, PVA is very grateful for this hearing, during which there has been an examination of the usefulness of Section 190 and the impact it has had in the removal of architectural barriers. As stated earlier, PVA supports the intent of Senator Dole's bill, S. 120, which would reinstate for two years the $25,000 maximum allowable deduction. However, we feel that the most plausible of all the proposals we have studied would be to increase the maximum allowable deduction to $100,000 and to make the provisions of Section 190 permanent. An identical proposal, currently in the House, has attracted over 100 co-sponsors.

Mr. Chairman and Members of the Subcommittee, PVA appreciates the efforts made by each of you to improve the well-being of handicapped persons. We are especially grateful that the Subcommitte has taken time to examine an issue that is of great importance to handicapped, disabled, and elderly persons. I feel confident that we share the same goals, to open society so that these persons can be active, productive citizens.

As shown earlier, under the discussion of types of disabilities found in the work force, Section 190 and its corresponding IRS regulations have addressed many of the needs of the mobility impaired, but have not addressed the needs of many other handicapped persons who are potential employees. For this reason, we ask that consideration also be given to expanding Section 190's provisions to permit a tax deduction for expenses incurred in making publicly-used, privately-owned facilities truly accessible to handicapped persons who have disabilities which have not been addressed in IRS regulations.

PVA has stated its full support for reinstatement of Section 190, and we have offered suggested amendments that would make that Section truly effective. PVA trusts that the Subcommittee understands that we would be supportive of other reasonable measures aimed at the removal of architectural barriers, if this Subcommittee concludes that it cannot endorse the suggested changes PVA has proposed.

Mr. Chairman, I appreciate the consideration extended to me by the Subcommittee and its staff. This concludes my statement, and I will be glad to answer any questions that I can.

PVA
PARALYZED
VETERANS
OF
AMERICA
CHARTERED BY THE CONGRESS OF THE UNITED STATES

1983 OCT 24 PM 12:50

October 18, 1983

Honorable Bob Packwood, Chairman
Subcommittee on Taxation and Debt Management
Senate Committee on Finance
SD-219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

Enclosed please find a letter from Mr. Arthur Altman of the Internal Revenue Service, in which he points out an error in PVA's testimony of September 26, 1983, before the Subcommittee on Taxation and Debt Management. As the enclosed correspondence and reply show, PVA mistakenly stated that the Internal Revenue Service had failed to include an analysis of Section 190 of the Revenue Code in Publication 334, Tax Guide for Small Business: it has been brought to our attention that that publication does contain a short analysis of the income tax deduction once available under that section.

Please understand that our statement was never meant in any way to mislead your Subcommittee. Despite our error, our point remains factually correct, that the deduction for removal of architectural barriers has not been publicized adequately to members of the business community or to IRS field personnel. Again, please accept my apologies for the error in PVA's testimony, which comes as some embarrassment to me because our organization prides itself in always provding Congress with factual, useful information aimed at improving the well-being of the Nation's veterans and handicapped citizens.

Sincerely yours,

Douglas K. Vollmer

Douglas K. Vollmer
National Legislative Director

Enclosures 4

801 Eighteenth St., N.W., Washington, D.C. 20006 (202) USA-1300

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

RECEIVED
SEP 29 1983
PARALYZED VETERANS OF AMERICA

Person to Contact:
Arthur Altman
Telephone Number:
(202) 566-4960
Refer Reply to:
PM:S:FP:P
Date: SEP 27 1983

Mr. Paul Cheremeta
Paralyzed Veterans of America
801 Eighteenth Street, N.W.
Washington, DC 20006

Dear Mr. Cheremeta:

On page 29 of the transcript of your September 26, 1983 statement before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, you commented that Publication 334, Tax Guide for Small Business, was silent concerning the deduction available before 1983 under Section 190 of the Internal Revenue Code (dealing with improving access for handicapped and elderly people).

We have reviewed the text of the publication and have found that the subject is explained on page 16 (please see enclosed copy). Similar text is also carried on page 20 of Publication 535, Business Expenses, a copy of which is also enclosed.

We share your concern that appropriate information on items of significant interest be made available to the public. It is for this reason that we want to call your attention to our coverage of the subject.

Thank you.

Sincerely yours,

Arthur Altman

Arthur Altman
Assistant Chief,
Technical Publications Branch

Enclosures

cc: Mr. John Liberty C:L

September 19, 1983

Honorable Dan Rostenkowski, Chairman
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Representative Rostenkowski:

The undersigned organizations, as representatives of handicapped, elderly, or disabled persons, request that the Committee on Ways and Means give its attention to the need for improved accessibility in publicly used, privately owned places of commerce, recreation, housing, and employment. There existed, until December 31, 1982, a tax incentive for the removal of architectural barriers. However, this provision of the Revenue Code (Section 190) has now expired and it has been three-quarters of a year since there was any incentive provided to businesses for the removal of architectural barriers.

Section 190 provided an option whereby business persons could deduct from taxable income those expenditures made for accessibility, instead of depreciating the capital improvements over a number of years. The maximum allowable income tax deduction was $25,000 for expenditures made to promote accessibility: this was the only provision in the Revenue Code aimed at removing barriers that impede the movement of handicapped, disabled, and elderly persons.

Many members of the U.S. House of Representatives have shown a desire for reinstatement and/or expansion of the provisions of Section 190, as illustrated by the five bills (H.R. 267, 669, 901, 988, and 1016) introduced in the House during the 98th Congress and by the total number of co-sponsors (150) who have endorsed these proposals.

We feel that H.R. 1016, which would make Section 190 a permanent provision of the Revenue Code and which would increase the maximum allowable deduction to $100,000, typifies the most realistic and satisfactory proposal aimed at addressing the removal of barriers: H.R. 1016 has 93 co-sponsors at this time.

Some of these bills have the support of prominent members of the Committee on Ways and Means, the Committee on Small Business, the Select Committee on Aging, and the Committee on the Budget.

The annual revenue costs of any one of these legislative proposals is slight: the Joint Committee on Taxation has estimated that costs would vary from $7 million to $40 million, depending upon the maximum allowable deduction that Congress should authorize.

Income tax incentives constitute the most effective way for business and the federal government to work together for the voluntary removal of architectural barriers that prevent the handicapped, elderly, and disabled from gaining access to places of commerce, housing, recreation, and employment.

Because of the urgent need for a tax incentive for the removal of these barriers, we request that the Committee on Ways and Means, upon Congress' return from the summer recess, set as one of its highest priorities the reporting to the House floor a bill to contain a permanent or long-term reinstatement of the provisions of Section 190 of the Revenue Code. We understand the many demands made upon your time, and we truly appreciate your cooperation and consideration.

Sincerely yours,

Max J. Beilke

Max J. Beilke, Legislative Counsel
National Association for the Uniformed Services
5535 Hempstead Way
Springfield, Virginia 22151

Brice G. Blower, President
Association of Local Governmental Agencies for the Disabled
c/o Suffolk County Office of Handicapped Services
65 Jetson Lane
Central Islip, New York 11722

Roberta Van Beek, Assistant Director of Governmental Affairs
National Easter Seal Society
1435 G Street, N.W.
Washington, D.C. 20005

Marvin O. Spears

Marvin O. Spears, President
National Rehabilitation Association
738 9th Street, S.E.
Washington, D.C. 20003

Douglas K. Vollmer

Douglas K. Vollmer, National Legislative Director
Paralyzed Veterans of America
801 18th Street, N.W.
7th Floor
Washington, D.C. 20006

David J Passamaneck

Lt. Col. David J. Passamaneck
National Legislative Director
American Veterans of World War II, Korea, and Vietnam (AMVETS)
4647 Forbes Boulevard
Lanham, Maryland 20801

Susan Scott

Susan J. Scott, OTR
Director, Government & Legal Affairs Division
The American Occupational Therapy Association, Inc.
1383 Piccard Drive
Rockville, Maryland 20850

Donald L. Harlow, Executive Director
Air Force Sergeants Association
P.O. Box 31050
Temple Hills, Maryland 29748

Robert R. Humphreys, Washington Counsel
The Arthritis Foundation
1120 20th Street, N.W.
Washington, D.C. 20036

Peter W Hughes

Peter W. Hughes, Legislative Counsel
American Association of Retired Persons
1909 K Street, N.W.
Washington, D.C. 20049

Phyllis Rubenfeld, Ed.D

Phyllis Rubenfeld, Ed.D.
President, American Coalition of Citizens with Disabilities
1200 15th Street, N.W.
Suite 201
Washington, D.C. 20005

Mr. CHEREMETA. S. 120 would specifically reinstate for 2 years the provisions of section 190 of the IRS Code which expired December 31, 1982. Under section 190, business could deduct the cost of renovations for improved accessibility to their facilities, such as ramps, curb cuts, signage, accessible bathrooms, and elevators. Without section 190, the business person must treat such renovations as any other long-term improvement which must be capitalized and depreciated over a number of years.

Improvements carried out under section 190 enable the handicapped to do many things: They allow us to shop, dine, play, work, and to live, with dignity and with the same freedom of movement as any other citizen enjoys.

Our written statement contains many examples of the kinds of improvements which have come about because of the deductions available under section 190. We have been told by members of our PVA chapters across the country and by other disabled individuals and groups that the availability of a Federal income tax deduction was one of the most powerful incentives to encourage business people to begin thinking about accessibility.

You must realize that accessibility improvements compete with other capital improvements which a business may be considering. For example, suppose an owner of an apartment complex is considering using available cash to upgrade the facility. Suppose further that the choice is between improved landscaping or the installation of ramps for wheelchair users. In the absence of special tax treatments for accessibility, the choice will be most likely for landscaping. The owner cannot be blamed for wanting to maximize the return on investment. After all, more present and potential tenants are likely to notice the landscaping than functional ramps.

The case for a national interest in returning disabled people to the mainstream of American life has been made and reaffirmed many times. We are pleased to have the administration's support on this issue. We realize that business cannot be ordered to provide accessibility and bear all the resulting costs, but we believe that Government to serve the national interest should provide incentives for improved accessibility.

To that end, Senator Robert Dole has introduced S. 120. We applaud the leadership Chairman Dole has demonstrated on this issue since 1976, and ask that consideration now be given to making deductions for accessibility permanent or at least extended significantly beyond a 2-year period.

Additional time is needed to allow disability rights organizations such as PVA to properly publicize this provision of the Tax Code. Short-term authorization of section 190 does not make news in small business circles, nor at the IRS, for that matter. Many field personnel never familiarize themselves with section 190, because they believe it to be too small and only a temporary measure. Even the IRS home office publication entitled "Tax Guide for Small Business" failed to include a reference to section 190 in the 168-page guidebook. Business must be made aware of these provisions and must also have the time to properly plan expenditures and renovations to include accessibility improvements.

Our written statement includes a summary of legislation introduced to this Congress and estimated revenue costs for them as determined by the Joint Committee on Taxation. We believe the costs are reasonable and will be somewhat offset by the disabled people returning to work and productivity.

While we believe that small business will be the chief beneficiary of this legislation, we believe that serious consideration should be given to raising the limits of the deduction so that businesses with multiple locations may also benefit. We note that it would take $48,000 to provide the same benefits as the $25,000 contained in the original provision in 1976.

In conclusion, PVA, the National Easter Seal Society, the American Association of Retired Persons, and many others, feel strongly that section 190 should be reinstated and improved. It is the only IRC provisions designed to help the handicapped, and it plays a crucial role in our effort to help disabled citizens remain active and productive.

This concludes my statement, and I will be happy to answer any questions I can.

Senator PACKWOOD. Thank you very much. I think we'll hear from Mr. Gashel first.

STATEMENT OF JAMES GASHEL, DIRECTOR OF GOVERNMENTAL AFFAIRS, NATIONAL FEDERATION OF THE BLIND, BALTIMORE, MD.

Mr. GASHEL. Thank you, Mr. Chairman.

My name is James Gashel. I am director of governmental affairs for the National Federation of the Blind, and as you have suggested with the other witnesses, I have submitted a written statement, so I will just try to summarize two or three points of it, if I could, and ask that it appear in full in the record.

Mr. Chairman, I guess that you would characterize the bottom line of our position on S. 120 as certainly a qualified endorsement. We believe that it is an essential provision and should be reenacted—that is, section 190 of the Internal Revenue Code was a valuable provision. It certainly backed the civil rights initiatives made in the Rehabilitation Act, and removal of the barriers to full accessibility is an important national objective; therefore, we support its reenactment.

We do recommend two basic changes in the provision, however, and I will concentrate on those.

The first recommendation we have relates to the addition of another type of barrier removal objective to the former statute. This refers to the problem that we have as blind people with certain types of barriers to communications.

Now, when we talk about communications barriers, what we are really describing is the type of barrier which affords blind persons and other persons with communicative kinds of disorders less access to information than other people might have. The obvious barrier to certain types of communication for us is that a lot of information is provided in ink print rather than in braille or some voice or recorded form. This is a barrier.

We would offer a definition of "communications barriers" which should appear in the statute, and we would propose this along with the architectural and the transportation barriers which were formerly enacted. This definition would read something like this:

> That a communication barrier would be any form, media, or format of information or recordkeeping, or any equipment used in receiving, transmitting, or processing such information and records which substantially limits access or comprehension by persons with impaired vision, hearing, or speaking skills.

We feel that with the addition of that particular objective and that particular definition, that corporations could do a much better job of removing certain types of barriers. And the practical possibility really exists. Today there are fantastic computerized reading machines which translate the printed page into full-word speech; there are talking computer terminals; there are braille devices that produce braille electronically as computer terminals; there are talking clocks—I've got one right here—which illustrate the possibilities that exist here. This happens to be a very low-cost item, but some of these items are far too expensive for an individual to provide for himself, and most corporations ordinarily don't provide them for employees. A tax incentive is therefore needed to overcome this particular problem.

Our second objective relates to a problem that we have as blind people with the type of expense that is not a one-time expense—purchasing a device such as I've illustrated can be done on a one-time basis, and while it may be a significant expense to begin with, it will go away or it will be amortized away.

However, there is an expense which we as blind people have in hiring continued sighted assistance. Like it or not, there is a fact that we as blind people will need readers and drivers in certain types of occupations—law, teaching, professional occupations, even entry-level jobs in social service occupations require a good deal of reading and translating of information from interviews onto the printed page.

We therefore propose a limited tax credit for employers who hire employees to provide essential sighted assistance to blind persons. And this tax credit would be limited only to those circumstances where it is necessary to have a sighted assistant to perform the essential functions of a job. And under those circumstances, then, we would propose a tax credit rather than simply an itemized deduction in the circumstances where a sighted assistant is essential.

Thank you very much.

[The prepared statement of James Gashel follows:]

National Federation of the Blind Testimony
Before the Subcommittee on Taxation and Debt Management
Committee on Finance, United States Senate
September 26, 1983

Mr. Chairman, my name is James Gashel. I am Director of Governmental Affairs for the National Federation of the Blind. My address is 1800 Johnson Street, Baltimore, Maryland 21230. I appreciate your kind invitation to appear before the Subcommittee today on issues related to S. 120.

Mr. Chairman, I appear before you today on behalf of the National Federation of the Blind, a nationwide membership organization of blind people representing the blind throughout the United States. We have a state affiliate in each state and local chapters in most sizable population areas. Our Federation is a vehicle for self-expression by the blind, themselves. In short, we are the blind speaking on our own behalf.

Statement of Support for Extension

The issue which brings us here today is the proposal to re-enact and extend the deduction found in Section 190 of the Internal Revenue Code covering expenditures made for removing architectural and transportation barriers. The deduction for removing barriers to the handicapped and elderly was originally enacted in 1976 and allowed to expire on December 31, 1982. The purpose of the deduction was to help increase employment opportunities for certain handicapped individuals who might be limited by architectural barriers or inaccessible transportation. The National Federation of the Blind supports extension of the barriers removal deduction as proposed in S. 120, with the addition of certain provisions, which I will be discussing.

In 1973, Congress took the first steps toward expanding private sector employment opportunities for the blind and disabled by requiring most federal contractors and subcontractors to take affirmative action in the employment and advancement of qualified handicapped individuals. Although not expressed in the statute (Section 503 of the Rehabilitation Act of 1973, as amended), an integral part of the affirmative action mandate has been the requirement by regulation that federal contractors make their facilities accessible to and usable by qualified handicapped individuals. Requirements such as this have stimulated much talk about physical accessibility and some change in the work sites of federal contractors and subcontractors. The question of cost of accessibility--who pays for it--however, continues to be a matter of considerable discussion and to some extent controversy.

The issue of the cost of physical accessibility is particularly acute in the private sector as opposed to the government or other public agencies. Expenditures for initiatives, such as physical accessibility, of public programs can be met by means of direct federal or state appropriations. But other than using the tax mechanism, Congress has no method on a broad scale to assist in the financing of barriers removal in the private sector. In 1976, Congress took the first steps toward participating in meeting the costs of physical accessibility in the private sector by enacting the tax deduction provision which S. 120 now seeks to extend beyond December 31, 1982.

So the rationale for the tax incentive approach is something in the nature of the the carrot and the stick. Congress has combined the civil rights provisions of the Rehabilitation Act of 1973, as amended, with a tax incentive to help in meeting any increased costs which might result. We view the tax incentive approach as an effective inducement to encourage voluntary compliance with an important civil rights law. As such, the deduction has continuing value in the vigorous implementation of civil rights policy affecting blind and disabled individuals.

Recommendations

Mr. Chairman, while we support extending the tax deduction for the removal of architectural and transportation barriers for the handicapped and elderly, we have come to offer certain proposals for modifying the provision in ways which relate to the needs of our particular constituency--the blind. These proposals are listed and described below as follows:

(1) Amendment to Permit Deducting the Cost of Equipment and Media for the Removal of Communications Barriers: In offering this proposal, we suggest that language be added to Section 190 of the Internal Revenue Code permitting the removal of certain barriers to communication not otherwise considered to be qualified architectural or transportation barriers under the provision which was formerly enacted by focusing almost exclusively on the built environment. The former law failed in our judgment to stimulate the removal of barriers to communication which are not caused specifically by the physical

features of buildings or facilities. Actually, Mr. Chairman, there are really no architectural or transportation barriers that prevent access to buildings and facilities by people who are blind. This is not to ignore the inconveniences which may be caused by certain structural features. But the key word is "prevent." In the sense of being "prevented" from using buildings or facilities by virtue of our blindness, we do not face barriers of the type which confront people who cannot physically obtain access. The problems of the blind are different in type as well as magnitude.

For this reason, and because of the language of the former statute, the income tax deduction for removal of barriers has not brought beneficial changes to improve opportunities for blind people. This is why we are suggesting that, in re-enacting the tax deduction for barriers removal, Congress should add the phrase "communications barriers" to appear in the statute along with architectural and transportation barriers. In addition, a definition of "communications barriers" should be incorporated to specify that such barriers include "any form, media, or format of information or record keeping (or any equipment used in receiving, processing, and transmitting such information and records) which substantially limits access or comprehension by persons with impaired vision, hearing, or speaking skills." Mr. Chairman, the need for and practical value of such an amendment is highlighted by the fact that advancing technology has provided new equipment and methods for communicating in ways other than the standard print media. I refer, for example, to devices which are now becoming available to enable blind people to read a printed page. One of these units is a small computer and camera assembly which scans the print characters and translates the visual images into full word recognizable speech. The device, known as the Kurzweil Reading Machine, can now be purchased for something like $25,000, with annual maintenance contract to keep the hardware functioning and the software up to date. Another device, about as large as an average sized cassette tape recorder, produces Braille symbols electronically and allows the user to record and retreive information stored on a standard tape cassette. This unit (known as the VersaBraille) can function as a self-contained information storage and retrieval system or it will operate as a computer terminal or word processor. Current price is approximately $6,500. One company (IBM) makes a talking typewriter which has a memory and will speak the words typed on the printed page and into its small computer. Other devices include talking computer terminals, high-speed computer driven Braille printers (costing about $16,000 apiece) and a new electronic Braille printer which will work in conjunction with a portable or personal computer.

The point I am making is that the apparatus is now available to provide blind people vastly increased access to information. The barrier of not having information (or not having access to it directly, if it existed only in the form of ink print) has been the most formidable physical obstacle facing the blind. To obtain access to information which we need for education, employment, and recreation blind people have developed and used alternative techniques to gather the knowledge we would acquire by reading print if we had normal vision. Now the electronic and computer age places us in the forefront of a communications revolution which can prove extremely advantageous to blind people if (and it is a big proviso) we can acquire the financing to take advantage of the new technology. This is where a tax incentive for the removal of communications, as well as architectural and transportation barriers becomes important.

(2) Sighted Assistance Tax Credit: Our second proposal for re-enacting the barriers removal tax incentive provision in a modified form is a tax credit to help in meeting the costs of obtaining essential and regular sighted assistance to enable a person who is blind to engage in a trade or business. It is recognized that employers who hire readers for blind employees may, under current law, deduct the wages of such readers as a business expense in the same manner as the wages of other employees are deducted. Also, blind individuals who employ readers may deduct the wages paid as a business expense allowed under Section 162 of the Internal Revenue Code.

These are the current tax provisions directly related to the costs of obtaining sighted assistance. But, they are relatively insignificant. For example, there is no additional tax advantage to a corporation for hiring a person who has a full or part-time assignment of providing reading or other sighted assistance to a blind employee. In the case of a blind individual who hires a reader or driver, there may be some reduction of the person's tax liability, but the benefit is minor compared to the cost and the fact that employing a reader or other assistant is necessary for the blind person to engage in the trade or business.

Any blind person who competes for employment, especially in business and industry (where the profit margin is the bottom line) can tell you that the most common concern of a prospective employer is the issue of continuing costs for employment of essential sighted assistance, such as readers and drivers. One-time nonrecurring expenditures (provided they are low enough) are usually not a critical impediment and can be eased somewhat by the tax deduction formerly allowed under Section 190 of the Internal Revenue Code. However, the greatest disincentive which employers have when considering blind job applicants is the possibility that there will be additional continuing costs for assisting blind employees in the routine functions of their jobs.

This fear of additional cost for the employment of blind persons may often be unfounded. However, it exists nonetheless. Many blind people are willing at personal expense to employ their own readers or drivers, if necessary. But, this is often a great financial burden despite the business deduction which can currently be taken under Section 162 of the Internal Revenue Code. By contrast, the use of a tax credit could stimulate greater employment opportunities for the blind throughout the private sector by rewarding employers who fulfill the needs of blind employees for essential readers, drivers, or other necessary continuing assistance. Of course, most jobs require no assistance whatsoever, so the tax credit should be fairly limited. We propose extending it only in those circumstances where the assistance is reasonably necessary to performing the essential functions of a job. A common example would be where a blind person engages in a trade or profession which relies heavily upon reading and research in print media and the processing of extensive written correspondence. Another case in point is the fact that blind people are virtually barred from entering sales occupations such as insurance, real estate, and similar trades which require extensive traveling to call upon clients and prospects. The costs of such travel under current circumstances, absent a tax credit, are prohibitive.

Summary and Conclusion

Mr. Chairman, to conclude and summarize this statement, I will indicate again that the National Federation of the Blind strongly favors re-enactment of Section 190 of the Internal Revenue Code which formerly allowed a deduction for the costs of removing architectural and transportation barriers for the handicapped and elderly. In addition, we have proposed that the statute be re-enacted in a modified form, calling first for the addition of "communications barriers," to appear in the statute along with the former provisions. We have suggested a specific definition for that section. Secondly and finally, we have proposed enactment of a tax credit to cover the expenses of employing necessary sighted assistance to aid blind persons in performing essential functions (such as reading and driving) required to enage in a trade or business.

Both of our proposals, Mr. Chairman, are based on our desire to expand opportunities for blind persons to engage in the private sector workforce of our nation. We think this can best be done by means of incentives to accompany the limited mandates for nondiscrimination which have already been directed by Congress. The tax incentive is an accepted and popular approach, as well as the best way that Congress has to encourage corporate America to expand employment opportunities for the blind and disabled. Seventy percent of the employable blind population is either unemployed or underemployed. This is a tragic statistic but a fact, nonetheless. Congress, the blind, and the business and industrial machinery of our nation must work together to implement an agenda of opportunities. Re-enacting Section 190 of the Internal Revenue Code in a modified form as we have proposed is a good place to continue this effort and we urge your careful consideration of the approach we are proposing.

Mr. Chairman, thank you for the invitation to testify before the Subcommittee today on this important issue concerning employment and advancement for the blind and disabled. I assure you, we in the National Federation of the Blind will be helpful in any way we can as you proceed to mark up and report specific legislation.

Senator PACKWOOD. Let me ask you this, Mr. Gashel.

It is unusual to have the Treasury Department support any of these bills here before us, and they support two of them today, including this one. Have you talked with them about your amendments?

Mr. GASHEL. No; we have not.

Senator PACKWOOD. I have no idea what their view will be, and we often pass many of these bills over Treasury's objection; but it clearly helps to have their support. So I will check your amendment with them and see what their position is.

Senator DANFORTH. We will do that.

Senator PACKWOOD. Thank you.

Senator Danforth.

Senator DANFORTH. No questions.

Senator PACKWOOD. Gentlemen, no questions. We appreciate it.

Mr. GASHEL. Thank you.

Senator PACKWOOD. Now let's go on to S. 1397. We have a panel consisting of Mr. William Dikis, Mr. Frank Hamsher, and Mr. Michael Ainslie.

Senator DANFORTH. Mr. Dikis.

STATEMENT OF WILLIAM M. DIKIS, PARTNER, BUSSARD/DIKIS ASSOCIATES, LTD., DES MOINES, IOWA, PAST CHAIRMAN, COMMITTEE ON HISTORIC RESOURCES, THE AMERICAN INSTITUTE OF ARCHITECTS, WASHINGTON, D.C.

Mr. DIKIS. Mr. Chairman.

My name is Bill Dikis. I am a practicing architect in Des Moines, Iowa, and past chairman of the American Institute of Architects' Committee on Historic Resources. I am appearing today on behalf of AIA to urge congressional support for S. 1397, and also I would like to comment briefly on S. 120.

With me this morning is Stanley Colby, AIA director of government affairs, behind me.

With regard to S. 120, we would like to express the institute's full and enthusiastic support for S. 120 as introduced by Senator Dole. By extending the $25,000 business tax deduction, or even perhaps, as mentioned in the January 26 Congressional Record, possibly taking it to $100,000, the legislation would serve greatly to expand the architectural access for our Nation's handicapped citizens.

Most buildings have a lifespan of over 40 years. Eighty percent of the buildings that will exist in the year 2000 are already in place. Much of the building stock was constructed when handicapped accessibility was not a priority, and thus we have still quite a job ahead of us. This legislation provides a valuable incentive to expedite the necessary improvements in handicapped accessibility across the Nation.

On the subject of S. 1397, the AIA finds the majority of the provisions contained in that bill necessary to correct the often unworkable Treasury interpretation of the 1978 to 1981 tax laws concerning rehabilitation tax credits. As stated by you, Senator Danforth, in the May 26 Congressional Record, Congress did not foresee at the time of the law's enactment that requiring 75 percent retention of the buildings' existing walls would deny tax incentives to many valuable and legitimate rehabilitation projects. You also noted that a severe barrier to rehab project developers arises every time the shape of the building is of a unique character and design. We are here to confirm that observation and underline that. A building that was rectangular in shape would fail the 75 percent of wall test if it were not square. If it were rectangular and you were simply to expand as a substantial portion of that project for economic reasons to the rear of that building, you would immediately fail the 75-percent test.

There are many other buildings that are E-shaped, U-shaped, and all kinds of other shapes that do not fall well into that provisions.

The American Institute of Architects recognized from the first enactment of these rehab credits that the 75-percent wall test as too restrictive and unworkable, and have worked since then to attempt to modify that, particularly because of this unique and unstandardized character of our historic and older structures.

Many significant structures of national and regional architectural significance have been casualties of this interpretation, and I think some of the other testimony this morning will mention specific examples of those.

As an architect involved every day with the preservation and rehabilitation incentives, I can address their value and their limitations. In my home city of Des Moines, Iowa, the credits have done a lot to change the economic and cultural health of our center city. I am personally involved with several projects myself that use these tax incentives, and they have done a great deal to work for the betterment of our downtown area.

The number of jobs and the tax revenue created downtown by the numerous projects have helped the construction industry in Des Moines survive through the recent recession. Of course anything that works in the favor of preservation tends to be labor-intensive and tends to be energy-conserving.

Historic preservation and rehabilitation has also played a significant role in the revitalization of our urban centers and central business districts.

Before concluding my remarks, I want to express the AIA's concern that section 1, part 3, of S. 1397 is substantially counterproductive to meeting the general goals of the legislation. The provision requiring the retention, in place, of 95 percent of the existing internal structural framework cannot be met in a large number of older structures existing for 40 years or more. These are often structurally unsound. It is often very difficult to meet the necessary increased weights and stresses of today's heavy office equipment—many of the older buildings have wooden floors and it makes it very difficult to deal with meeting that loading.

In summary, we want to completely support S. 1397, with the 95-percent exclusion.

[The prepared statement of William M. Dikis follows:]

THE
AMERICAN
INSTITUTE
OF
ARCHITECTS

1735 New York Avenue, N.W.
Washington, D.C. 20006
Telephone: (202) 626-7300
Cable Address: AMINARCH
Telex: 710822 1112

S. 120
S. 1397

A STATEMENT BY

William M. Dikis, AIA

COMMITTEE ON HISTORIC RESOURCES
THE AMERICAN INSTITUTE OF ARCHITECTS

BEFORE
COMMITTEE ON FINANCE
TAXATION & DEBT MANAGEMENT SUBCOMMITTEE

U.S. SENATE

SEPTEMBER 26, 1983

Mr. Chairman, my name is William M. Dikis, AIA. I am a practicing architect in Des Moines, Iowa and past Chairman of The American Institute of Architects' Committee on Historic Resources. I am appearing today on behalf of the AIA to urge Congressional support for S. 1397 and the essential role that federal tax incentives have played in the preservation of our national heritage. However, I would first like to comment briefly on S. 120 which extends business tax deductions for improvements in handicapped access. Accompanying me this morning is Stanley Kolbe, AIA Director of Government Affairs.

S. 120

On behalf of The American Institute of Architects, the professional association representing this nation's architects, I want to express the Institute's full and enthusiastic support for S. 120, which has been introduced by Senator Dole. The AIA is also working to secure passage of the House version of S. 120, H.R. 901.

By extending the $25,000 business tax deduction for the costs incurred in renovating facilities two more years beyond the December 31, 1983 expiration date, the legislation will greatly serve to expand architectural access for our nation's handicapped. The AIA believes that through the removal of certain architectural and transportation barriers that limit accessibility by disabled persons, S. 120 will serve to fulfill the rights and productive potential of all of our citizens. At this point, I would like to make a few observations about this nation's building stock. Most buildings have a life span of over 40 years. Furthermore, 80 percent of the buildings that will exist in the year 2000 already are in place. Much of this building stock was constructed when handicapped accessibility was not a priority. However, the AIA believes that, just as buildings are upgraded for energy efficiency, they will also be upgraded or replaced with features that increase levels of accessibility. This legislation can provide a valuable incentive to expedite the necessary improvements in handicapped accessibility across the country. For this reason, the Institute pledges to work with Congress to insure passage of this legislation during this session of the 98th Congress.

Over the past several years, both the public and private sectors, including the architectural profession, have made noteworthy advances in reducing impediments to full participation by disabled persons in the normal activities of society. I am proud that the AIA has had some share in these advances and been able to educate both architects and the public to enhance opportunities for the disabled. Evidence of the architectural profession's commitment is provided through our strong emphasis on barrier free design and by our participation in the development of revised accessibility standards with the American National Standards Institute (ANSI).

The AIA believes that partnership between the public and private sectors, as well as between able-bodied and disabled persons is essential for progress toward a more barrier free environment.

Without doubt, additional progress is needed in this area. S. 120 represents an incentive mechanism to meet our nation's commitment to the handicapped.

The problem of creating an accessible environment is exacerbated in existing structures because these buildings were built before barrier free design was part of architecture curriculum. Installing elevators and other accessibility features obviously becomes an expensive proposition in existing buildings. To deal with this issue, a number of states and a few cities have tough legal requirements for existing buildings in their building codes. These provisions require buildings under these states and cities' jurisdiction to be made barrier free when they are remodeled. For example, both the state of Massachusetts and the city of Chicago have effective enforcement programs for new and existing construction, as well as inspector training programs on barrier free design. These programs are designed to overcome inertia, insensitivity and inflexibility, which can be caused by unfamiliarity with barrier free requirements. The federal tax incentives, which would be extended two years under S. 120, have played a significant role in encouraging businesses to remove the handicapped access barriers.

To conclude my remarks on S. 120, I want to offer you the support of the architectural profession and the resources of the AIA in your efforts to pass this important tax legislation and improve handicapped access in the built environment as soon as possible. It is a goal we have long sought.

S. 1397

Mr. Chairman, the AIA finds the majority of the provisions contained in S. 1397 necessary to correct the often unworkable Treasury interpretation of the 1978 and 1981 tax laws concerning rehabilitation tax credits. As stated by Senator Danforth in the May 26 Congressional Record, Congress did not foresee at the time of the law's enactment that requiring 75 percent retention of the building's existing walls would deny tax incentives to many valuable and legitimate rehabilitation projects. As also noted by Senator Danforth, a severe barrier to rehab project developers arises everytime the shape of the building is of a unique character and design. Senator Danforth mentioned a non-qualifying St. Louis structure where the proposed rehabilitation would preserve three of the four existing walls; this is the type of ineligible project an architect often confronts. A building that was rectangular in shape would also fail the 75 percent of walls test if rehab expansion to the rear of the project retained three of four walls but replaced the backwall and enlarged the building. Numerous examples of the unworkable nature of the 75 percent text exist in every state in the nation no matter how diligently architects may attempt to meet the rehab objectives the Congress stated when passing rehabilitation incentives only a short time ago. While the AIA membership worked long and hard to pass these original incentives, we were unsuccessful in our attempts to modify the walls test. We hope these necessary changes can occur in this year's tax bill.

The American Institute of Architects, as a matter of policy, has recognized, since first enactment of the rehab credits, that the 75 percent of the walls test was too restrictive and unworkable. We have communicated to Congress and the Executive Branch on many occasions the need to modify the rehab test to reflect the unique and unstandardized character of our historic and older structures. When the Internal Revenue Service issued its interpretation of the rehabilitation qualification test October 28, 1980, the AIA immediately responded to IRS and the Congress with serious objection to the regulations. Approximately three years ago the AIA stated in its response to the regulations:

> "...we have serious reservations about 1.48-11 paragraph 5, 'Retention of 75 percent of external walls.' By noting that a common wall is not an external wall, we feel that the proposed regulations severely restrict from qualification that class building type most eligible for adaptive use and rehabilitation -- row-type commercial and residential structures typical of the urban northeast. As it stands, the language would serve to stifle many appropriate and creative architectural solutions to the problem of re-use of older buildings, which we believe to be the intent of the regulations. In view of

these reservations about the regulations as proposed, we urge that public hearings be held."

While the rehab credits Congress passed in 1978 and 1981 have had a positive and profound impact on the urban design of our nation's cities, many exceptional structures of national and regional architectural significance have been casualties of the IRS/Treasury interpretation of the rehabilitation incentives. S. 1397, by modifying the rehab test, encourages rehabilitation of these unique architectural and design treasures, recognizing them as valuable economic assets.

As an architect involved every day with the preservation and rehabilitation incentives, I can address their value and their limitations. In Des Moines, Iowa for instance, the credits have radically changed the economic and cultural health of our center city. The number of jobs and the tax revenue created downtown by the numerous rehabilitation projects have helped the construction industry in Des Moines survive through the recent recession. New construction, on the other hand was economically infeasible. Had S. 1397 passed two years ago, I can assure you more could have been done to rehabilitate our cities than was possible under the current rehab restrictions.

It is important to note that historic preservation, adaptive use and retrofit activities also afford the nation a clear opportunity to conserve our increasingly expensive energy resources. As I mentioned earlier, eighty percent of all buildings that will exist in the year 2000 are in place today and represent an energy investment which few understand. Studies by the President's Advisory Council on Historic Preservation have demonstrated that rehabilitation of existing buildings requires far less initial energy than the demolition, construction and operating needs of comparable replacement buildings. In addition, rehabilitation-related construction activity makes good economic sense. Rehab projects create jobs, provide job-training and enhance the skills of those involved. Furthermore, once employed, workers on preservation projects are not subject to the normal seasonal fluctuations of the construction industry as most of the renovation is completed in an enclosed area. I would also call to the Committee's attention reports by the Advisory Council on Historic Preservation which found that the cost of restoration per square foot was from one-fourth to one-third cheaper than that of new construction. It has been estimated that renovation may cost from $15 to $40 per square foot, depending on the utilization of previous space and materials, as compared to $80 per square foot for new construction.

Historic preservation/rehabilitation has also played a significant role in the revitalization of our urban centers and central business districts. Many rehabilitation projects have been located in our inner cities, preserving the architectural, historic and cultural heritage of the area, while at the same time stimulating real estate values and general economic growth.

Before concluding my remarks, I want to express the AIA's concern that Section 1 Part III of S. 1397 is substantially counterproductive to meet the general goals of the legislation. The bill's provision requiring the retention in place of 95 percent of the existing internal structural framework cannot be met in a large number of older structures existing for 40 years or more. These buildings are often structurally unsound and in need of vast internal structural improvement if they are to be useable as commercial office or retail space. The weakened internal structure of our older buildings often cannot handle the increased weights and stresses of today's heavy office equipment without structural modification. Of equal importance is the fact that many of the older buildings have wooden floors and structural elements that will not meet fire safety and building code requirements in many areas of our country. Utilizing 95 percent of a faulty, aged internal structure as a qualification for rehab credits only worsens the current situation. We suggest that Section 1, Part III be dropped from the bill to better effect the goals Senators Danforth and Eagleton envisioned when they introduced S. 1397. Beyond this objection, the Institute finds the legislation long overdue and urgently needed to better preserve the urban fabric of our cities.

I appreciate the opportunity to testify before you today on a subject of high priority to the nation's architects, developers and preservation-minded citizens. It is important to remember that older structures, especially architectural treasures, are part of our nation's past and its cultural heritage. In addition, these structures represent underutilized economic potential for our cities. We urge the adoption of S. 1397 with the modification to Part III as expressed above.

Thank you for this opportunity to appear before you.

T580C

STATEMENT OF FRANK HAMSHER, COUNSEL FOR DEVELOPMENT ON BEHALF OF THE CITY OF ST. LOUIS, MO.

Mr. HAMSHER. Thank you, Senator Danforth.

I am pleased to be here to present testimony on behalf of the city of St. Louis and Mayor Schoemehl in support of Senate bill 1397.

The investment tax credit for rehab of older and historic buildings has proved to be a highly effective means of accomplishing its stated purpose, which was to encourage the rehabilitation of historic structures and older structures and to preserve and encourage the reinvestment in the fabric of our downtowns and the fabric of our neighborhoods, particularly in our older central cities. It has been a very great assist to older cities like St. Louis which have a vast supply of fine older buildings which have been too long neglected by the investment and user communities. In fact the investment tax credit has had a great effect over the last 2 years in encouraging, stimulating, and moving along the rehab of our downtown area, our neighborhoods, and many of those fine older buildings.

A vast amount remains to be done, however. In St. Louis, for example, some 5 million square feet of underutilized or vacant space exists on two main traffic arteries in the downtown area. Thousands of buildings in the neighborhoods remain to be rehabilitated and brought back into productive use.

The ITC, which has been so helpful in stimulating activity along those lines, however, cannot accomplish its purpose fully due to some technical arbitrary restrictions which were included within the current language of the statute.

Senate bill 1397 would correct one such technical problem, which relates to the requirement that 75 percent of the existing external walls of an older or historic building remain in place as external laws. That requirement has proved to be one which has ruled out or made more difficult the rehab of a great number of buildings which in fact the ITC provisions were not intended to rule out or make more difficult.

It has been unduly restrictive particularly for odd-shaped buildings: E-shaped buildings, U-shaped buildings, L-shaped buildings. St. Louis has a wealth of all of those kinds, both in downtown and in the neighborhoods. It also can adversely affect some rectangular buildings. It has made very difficult, or in some cases impossible, additions to and connections of several adjacent older or historic buildings which need to be connected in order to make an economically viable project. And it can virtually eliminate any kind of an addition to any kind of a row structure, whether it be a residential or a commercial row structure.

In many cases, additions to such structures are vitally necessary to meet modern needs—modern needs in terms of heating, air conditioning, ventilating, and so on; in terms of elevator use, in terms of interior use of buildings.

Modifications are frequently necessary which will in no way harm the existing fabric of the area in which the building is located, will in no way harm the building itself, or will in no way harm its esthetic appeal or its appeal at the street level. And in fact the additions to such buildings can help retain those buildings as a part of the vital fabric of a downtown or neighborhood area.

Senate bill 1397 would ease those restrictions, and would in fact serve the original purpose that the Investment Tax Credit had, which was to encourage and stimulate the rehabilitation of older historic buildings, to modify investment decisions, to redirect investment in the direction of rehab of our older buildings and the fabric of our core cities such as St. Louis.

This provision would make that investment tax credit effective for odd-shaped buildings, for buildings which are not square, for buildings needing modern facilities, for buildings needing to be joined. It assures, through standards contained in the bill, that the rehabilitation will in fact still be genuine rehabilitation and will not in fact be new construction.

As a representative of one of our fine older cities with a wealth of fine older buildings to be rehabilitated still, I urge this Senate to pass the Senate bill 1397 to make that tax credit effective in all situations.

Thank you very much.

[The prepared statement of Frank Hamsher follows:]

STATEMENT OF FRANK HAMSHER

Office of the Mayor: Counsel for Development
City of St. Louis, Missouri

Mr. Chairman, I am Frank Hamsher, Counsel for Development for the City of St. Louis, and I am pleased to be here to testify on behalf of Mayor Vincent C. Schoemehl, Jr. and the City in favor of Senate Bill 1397.

Senate Bill 1397 would amend Section 48 (g) of the Internal Revenue Code which provides an investment tax credit for rehabilitation expenditures for qualified rehabilitated buildings. Congress passed the investment tax credit for rehabilitation expenditures in recognition of the enormous capital investment that this country has in older buildings. It was recognized that many of these buildings, primarily in central cities and older neighborhoods were declining. Older cities like St. Louis were experiencing very significant disinvestment in and abandonment of older buildings. This resulted not only from basic demographic and economic trends, but also from changing architectural and engineering designs affecting the exteriors of the builidings, the internal placement and flow of activities, and mechanical systems. Congress properly recognized that the buildings were not obsolete and ought not to be destroyed, that the fabric of downtowns and older neighborhoods depends upon re-use of existing structures. The investment tax credit has been an effective method of changing investment patterns in favor of rehab.

In St. Louis, the rehab ITC has begun to transform both downtown and neighborhoods. Good buildings which had long been neglected have been given new life. For cities like St. Louis, whose fine old building stock is one of its major assets, the rehab ITC has been a major benefit. But to make the rehab ITC work as Congress intended, some technical changes are needed to fulfill the intent of Congress and eliminate some inflexibility in the interpretation of the rehab credit.

To be a "qualified rehabilitated building" a building and its structural components must meet the tests of Section 48 (g) of Internal Revenue Code. The test requires that the building be "rehabilitated" as defined in the regulations, that it be placed in service before the beginning of rehabilitation, that twenty years have elapsed since the prior rehabilitation or construction, and, the subject of the present bill, that "seventy-five percent or more of the existing external walls (be) retained in place as external walls in the rehabilitation process."

The seventy-five percent retention requirement for external walls has created problems in the rehabilitation of buildings which are not square. In order to be used efficiently in modern circumstances, many older buildings require some external modifications - commonly on the back or a side which was never intended to be viewed from the street and which is frequently undistinguished architecturally. If a building is rectangular, the only side upon which new construction may be added and meet the 75% requirement is one of the shorter ends of the rectangle.

In addition, many older buildings were constructed in the shape of an "L", a "U", an "E" or other multi-winged shape which may affect efficient utilization of the building. Often, the shape of the older building was chosen to facilitate ventilation in the era predating air conditioning. The opening is often on the side to which additions may be constructed. Unfortunately, if a rehabilitation project involves the enlargement by construction in the "inside" spaces of the original building, such as by filling in the opening of a "U" shaped building, the rehabilitated building may fail to meet the 75% requirement for external walls. Many fine old buildings in downtown St. Louis are of this nature and the 75% requirement as it currently stands could be an impediment to attracting rehab of such buildings.

The requirement also limits the ability to re-use buildings by joining several older buildings with new construction. This can particularly be a problem in the rehab of small older multi-family residential buildings.

To the extent that the building's "non-square" shape or the need to make appropriate additions or connections prevents rehabilitation expenditures from qualifying for the investment tax credit, the function of the investment tax credit to encourage the rehabilitation of the building has failed. The 75% requirement is an artificial - essentially arbitrary - constraint. It causes the viability of the rehabilitation project to depend entirely on the shape and configuration selected for a building decades ago. It is, of course, possible to rehabilitate a building in an architecturally pleasing and useful manner and yet close in the "open space" or construct an addition off the long side of a rectangular building.

The requirement for retention of the existing internal framework is similar to that currently found in Regulation Sec. 1.191-2 (e) (5) which excludes new construction from the rehabilitation investment tax credit. The present regulation provides that if the internal structural framework of the building is replaced, the work will be considered new construction and not rehabilitation. The amendment insures that the basic structural framework is retained but allows the minor changes often required by new construction to be made.

Under the amendment, half of the present external walls must be retained as external walls and seventy-five percent of the walls must be retained in place. These provisions guarantee that the older building will be retained and used. The purpose of investment tax credit will be retained. The country will be using its existing capital investment. Older cities with abundant resources of older buildings will be better able to attract users and investors to their existing buildings. Additions can be added that do not compromise the architectural beauty of the past. Investment can be encouraged where it is needed most, in the downtowns and in those places where decline and abandonment have occurred in past due to changing designs and activities. Investment in the older cities and communities of this country will be encouraged through the marketplace without the artificial constraint imposed by the architectural form selected many years ago.

STATEMENT OF MICHAEL L. AINSLIE, PRESIDENT, NATIONAL TRUST FOR HISTORIC PRESERVATION, WASHINGTON, D.C.

Mr. AINSLIE. Senator Danforth, first let me commend you on introducing this important piece of legislation. The National Trust is delighted to have participated in 1981 in the support of rehabilitation investment credit provisions and has seen the enormous success throughout the country of those provisions. As you know, some $4 billion of investment has occurred resulting from the investment credit and other historic preservation incentives in place since 1976.

Clearly, the 75 percent of external walls test has been one of the major problems with the existing legislation, and we are in support of changes to that test. We do, however, have two additional concerns that are not addressed in this legislation which I would like to mention today, and one significant problem with the legislation.

The National Trust recently retained the firm of Peter D. Hart Research Associates to conduct a major national survey of people who have used and those who have not used the investment incentives, to learn more about these problems. We were interested to learn that one of every two projects that have been undertaken under the investment credit provisions would not have been undertaken without the incentives.

We also learned that 45 percent of those developers not using the incentives mentioned the problem of the 75 percent of walls test as a major reason for their not using the tax credit

The first of the two provisions which we are specifically concerned about that are not addressed in this bill is the present requirement that 75 percent of external walls be retained in place. The words "be retained in place" are our concern, and they continue on in the proposed legislation. This precludes major reconstruction of walls, which is frequently needed and in our opinion is good preservation technique fully consistent with the Secretary of the Interior's guidelines. We urge that some language allowing for reconstruction where materials are reused be allowed, and that the test "be retained in place" be enlarged to include that kind of reconstruction.

A second problem which is not addressed is that of distinguishing between existing external walls and original external walls. Frequently there have been accretions, additions to buildings, and in fact the current test frequently, we find, leads to the removal and the demolition of the original fabric of the building and the retention of the more insignificant additions that have been added over the years. This is not as big a problem with historic rehabilitations, where the State historic preservation officer must certify that the rehabilitation is historic but it is a major problem with the 15 and 20 percent tax credits for one rehabilitation of 30- and 40-year-old buildings where there is no review and certification process.

My colleague from the AIA has spoken about the significant problems, and we see them as absolutely major problems that would result from the addition of a new test that 95 percent of the existing internal structural framework be retained inplace. This is a very inflexible provision; and while we certainly endorse the idea of retaining internal structure where possible, we see many of the problems and even more than AIA has mentioned. There are certainly building code problems, seismic code problems, and other problems resulting from difficulty of measurement.

Finally, if I could mention one other provision which is not addressed and which we feel is a major problem: That has to do with the provision that requires a substantial rehabilitation, called the "substantial rehab test." On which we have testified previously. We hope that your committee will in the future review the provision requiring that the rehabilitation exceed the adjusted basis in the building. We think there are alternatives to that, and we think the language used in the accelerated cost recovery test under section 168(f)(1)(C) would be an improved test, rather than the existing substantial rehab test.

In closing, let me just mention that on the 1st of January in 1984 a provision of the 1976 act lapses. This is the provision which provides a capitalization of demolition expenses of a National Register building. While this is a provision that we think has had effective use around the country, we would like to remind your committee that we do not believe that tax benefits, that is, from the expensing of the residual basis and the cost of demolition, should be conferred on individuals or corporations who are demolishing historic buildings.

I must say that 3 years ago we testified with Mayor Conway of St. Louis to repeal the other demolition provision, which denied accelerated depreciation at that time, and we supported that change. It was eliminated then from the code. One provision was left, however, that being the denial of the ability to write off the remaining basis of a building and the expenses related. This expires on the 1st of January 1984, and we would like to urge that it be extended at that time.

Thank you, sir.

[The prepared statement of Michael S. Ainslie follows:]

STATEMENT OF MICHAEL L. AINSLIE
PRESIDENT OF THE NATONAL TRUST FOR HISTORIC PRESERVATION
BEFORE THE SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
CONCERNING AN ALTERNATE PERCENTAGE OF WALLS TEST, S. 1397

September 26, 1983

Mr. Chairman and Members of the Subcommittee, the National Trust for Historic Preservation is pleased to have this opportunity to present its views on S. 1397, a bill to amend the Internal Revenue Code to provide an alternative test for qualification for the rehabilitation tax credit.

The investment tax credit is the single most important factor cited by developers in deciding whether to initiate the rehabilitation of an historic building. Our research confirms Department of the Interior statistics that one of every two certified rehabilitation projects would not have been undertaken were it not for the existence of the targeted historic preservation tax incentives. Actual and planned investment in historic rehabilitation projects certified for the tax incentives has totaled $3.95 billion in the six years since the creation of preservation tax incentives. Approximately one-third of that investment was certified in 1982 indicating, in part, a growing interest by new investors in the restoration of our nation's building stock. This is one of the few tax incentives I am aware of that has worked exactly as Congress has intended it to work. However, refinements are needed. While we do not support the bill before the Subcommittee, it does address one of the difficulties some tax projects have had with the bill's eligibility requirements.

We believe the existing 75% of walls test should be revised, but not as proposed in the pending bill. In addition, we want to alert you and the Committee staff to two additional issues in the historic preservation tax incentives -- the substantial rehabilitation minimum expenditure test and the expiring demolition provisions.

The 75% of Walls Requirement

The basic purpose of the 75% of external walls retention requirement is to assure that only rehabilitation and not new construction is encouraged through the investment tax credits. At the same time, Congress sought to provide an objective and self-administering test. Clearly a distinction must be made between new construction and rehabilitation. Experience with the requirement has demonstrated, however, that a variety of conditions arise in which the test has hamstrung important rehabilitation projects. The Ferry Building in San Francisco; the Willard Hotel, the Evening Star and the Apex buildings on Pennsylvania Avenue in Washington, D.C.; and the National Historic Landmark

Union Station in St. Louis are well-known examples of projects which have had difficulty meeting or cannot meet this test.

Further evidence of the national scope of this problem is contained in a study by Peter D. Hart Associates, Inc., a nationally-known market research organization. To gather information for the Congressionally mandated tax study conducted by the National Trust for the Advisory Council on Historic Preservation, Federal Taxation and the Preservation of America's Heritage (April 1983), the Hart firm surveyed by telephone a population of persons who had used the tax incentives and a control population of real estate developers, syndicators and counselors who had not taken advantage of the preservation tax incentives. Forty-five percent of those surveyed identified the 75% of walls requirement as a problem.

The principal difficulty with the 75% of walls requirement comes with the imposition of what appears to be a clear and objective standard that, in actual application to a diversity of older building types, is arbitrary and inequitable. An example of this problem can be seen in the building with an irregular plan, such as the E-shaped building which prompted S. 1397 or the Apex Building on Pennsylvania Avenue. For this and other reasons detailed below, the Advisory Council on Historic Preservation during its August meeting recommended developing more flexible tests to qualify for the rehabilitation tax credit for certified historic structures. The Advisory Council includes representatives from the Departments of Treasury and Interior.

S. 1397 proposes an alternative three-part test whereby (1) "50% of the external walls must be retained as external walls"; (2) "75% or more of the existing external walls are retained in place (but not necessarily be retained as external walls)"; and (3) "95% of the existing internal structural framework is retained in place" after the rehabilitation process. We agree that a change in the 75% of walls requirement is warranted and necessary, however, the formula proposed in S. 1397 will provide a standard that is too restrictive to be useful on a national scale. The 95% rule, if intended to provide more flexibility, would actually be counterproductive and more inflexible than the present requirement. From the point of view of an architect or developer, this standard would be overly stringent and could lead to the situation where the existing structural framework had to be reinforced in order to be retained, adding to the rehabilitation costs.

Neither the existing test nor the alternative test meet the major problems with the existing 75% of walls test that are being encountered and which have prompted the National Trust to develop its own recommendations on this issue. Let me briefly summarize them for you.

1) The requirement that external walls be "retained in place" in the rehabilitation process creates a potential problem for those historic buildings needing some wall reconstruction. The statutory requirement that external walls be "retained in place...in the rehabilitation process" may preclude dissassembly and reconstruction as permitted under the facts and

circumstances test in the regulations under Treasury regulations interpreting Code Section 191. Similarly, the proposed regulations under the repealed 10% investment tax credit for 20-year old commercial buildings allowed replacement of non-structural curtain walls provided the "structural framework" of the wall was retained in place.

Reconstruction is a legitimate preservation technique and fully consistent with the Secretary of Interior's Standards for Rehabilitation. The ability to dissassemble, reinforce, and reassemble particular walls may be essential for the preservaton of substantially deteriorated historic buildings. It is also necessary when fitting a building with structural steel beams in the rehabilitation of historic buildings in cities like San Francisco where such buildings often do not meet current seismic code requirements.

2) The requirement that external walls be retained in place as "external walls" in the rehabilitation process may be interpreted (as the Treasury Department did in its proposed regulations under the 10% tax credit) to require that external walls have one face exposed to the weather or the earth. Such interpretation would make it difficult to enclose external walls with covered arcades, as was proposed for Denver's Tivoli Brewery, Milwaukee's Grand Concourse, and other commercial projects which seek to integrate several separate buildings into an urban shopping environment. The first two elements of the bill would address this problem.

3) The test fails to distinguish between existing external walls and original external walls. This may have the unintended result of allowing demolition of an historic building's original building fabric. This could occur when the historic building had been expanded with a nonsignificant addition. Because the 75% of walls test is confined to "existing external walls" as opposed to original building fabric, it is conceivable that a disproportionate amount of original wall could be removed while satisfying the 75% test. This may be a problem for National Register eligible buildings rehabilitated under the 15 or 20% tax credits. It should not be a problem for certified rehabilitations because of the safeguards provided by the Secretary of the Interior's review and certification process.

4) The test fails to distinguish between significant and nonsignificant wall surfaces. This may hamper the effort to rehabilitate the building in sympathy with the Secretary of the Interior's Standards which provide for rehabilitating historic buildings to meet contemporary market requirements.

Because historic buildings are often thought to be too small for contemporary office and commercial use, the ability to blend new construction with the existing building fabric may be essential to allow these properties to be made economically viable in the commercial market. There are many cases, however, when the Department of Interior, through its review and certification process will not allow any walls to be removed in order to fully protect the historic significance of the building.

5) The requirement presents practical problems for taxpayers and the Internal Revenue Service in determining the measurement of the external walls of historic buildings to meet the test. Unlike the buildings constructed in more recent decades with very simple vertical planes, many historic buildings have complex external wall configurations. These can include parapets, towers, arcades and courtyards. The difficulty of measurement of these wall surfaces has confounded many projects under this standard. These difficulties are demonstrated in a recent private letter ruling for the Willard Hotel in which the Internal Revenue Service was forced to go to great lengths to distinguish between the "essentially horizontal" and the "essentially vertical" elements of the mansard roof with its mansard-like curved penthouses.

The National Trust's tax study has identified two alternatives to remedy the problems posed by the 75% of walls test. One deals with certified historic rehabilitations by exempting certified historic rehabilitation from the 75% test, relying on the Department of Interior certification process to determine the appropriateness of the rehabilitation plans, while the other makes applicable to all rehabilitations statutory clarifications to eliminate some of the difficulties created by the current standard.

The Secretary of Interior's review and certification process assures that no historically significant walls are covered up or destroyed in a certified rehabilitation. Exempting certified historic rehabilitations from the statutory 75% of walls test would assure that all historic projects currently screened out by the 75% of walls test could be done.

If the Subcommittee wishes to consider a change in the wall's requirement for projects using the 15% or 20% tax credits, we would suggest as a model the standard contained in the Department of Treasury regulation 1.191-2(e)(5). That regulation defined new construction as the replacement of the internal structural framework of a building and one or more outer walls. The structural framework and outer walls are not considered to have been replaced, however, if they are disassembled and reassembled during rehabilitation and the reassembled portion uses at least 75% of materials original to the structure.

The Substantial Rehabilitation Test

We believe it is appropriate to consider the 75% of walls requirement together with the other major objective test for qualification: that the taxpayer must incur rehabilitation expenditures that exceed the greater of $5,000 or 100% of the adjusted basis in the building. Like the 75% of walls requirement, the purpose of the test is to assure that only properties that are rehabilitated in fact will qualify for the credit. The expenditure level in relation to basis is a useful objective standard to circumscribe the class of projects potentially eligible for the credit.

However, in application, the test frequently creates arbitrary and unintended results. For example, the test discriminates where a building has recently changed hands or is in a high value area. The test has other disadvantages as well. The need for rehabilitation costs to exceed adjusted basis may encourage over-improvement of the building in a way that is wasteful and inconsistent with sound preservation technology. The test may also serve to eliminate the incentive for small-scale rehabilitation projects.

This 100% of basis test as now formulated favors current owners who have depreciated their buildings over a long period of time. Most renovations occur when a building changes ownership; thus the test may actually thwart the overall purpose of encouraging renovation. This could occur where the cost of acquisition far exceeds the amount of rehabilitation needed to put the building in service for contemporary use.

Entering into partnership or joint venture agreements with the current low-basis property owners is a sophisticated way to avoid the test. But it increases the transactional costs of the tax credits and is unnecessarily wasteful. This is inequitable to the owner or developer of an historic property whose incentive decreases as transactional costs increase. Finally, because the minimum expenditure threshold is a cliff test; the taxpayer may not know if the test has been met until the rehabilitation work is completed and all costs are incurred.

The National Trust has identified four legislative recommendations which might be applied to remedy these problems: (1) the exemption of certified historic rehabilitations from the test; (2) the adoption of a "facts and circumstances" test to be applied on a case-by-case basis; (3) the reduction of the threshold of expenditures necessary below 100% of the building's pre-rehabilitation adjusted basis; or, (4) the reduction to the lesser of the adjusted basis or a minimum expenditure level of $100,000.

The National Trust recommends that the Congress exempt certified rehabilitations from the substantial rehabilitation test. If as an alternative the Congress wants to retain an objective test, then we urge the consideration of the substantial improvement test used to qualify for accelerated cost recovery under Section 168(f)(1)(c) -- an expenditure threshold of 25% of adjusted basis.

The Demolition Disincentive

Code Section 28, enacted in the Tax Reform Act of 1976, denies current deductions for losses and expenses incurred in the demolition of an historic property. Instead, the taxpayer must charge the expense and loss to the capital account of the land on which the demolished structure was located. In effect, demolition must be added to the cost of acquiring the land -- a cost which cannot be depreciated and which can only be recovered upon sale of the property. This section will expire on January 1, 1984, absent action. While there has been some uncertainty about the effectiveness of the disincentive, based mainly on a lack of public awareness of its existence, the National Trust believes that the Internal Revenue Code should not confer tax benefits on taxpayers who willfully demolish historic buildings that are included in the National Register of Historic Places.

The demolition disincentive remains an important element of the public policy framework for the protection of historic buildings. Its removal would render the Internal Revenue Code internally inconsistent by subsidizing the destruction of historic properties while, at the same time, encouraging their preservation through the rehabilitation tax credit. In economically marginal cases, the absence of the demolition provision could end in the destruction of buildings. More generally, its removal will send a very negative, pro-demolition signal from the Congress.

Senator DANFORTH. Gentlemen, thank you very much. This is exactly why hearings are so important. We are given the opportunity to hear from people who have much more expertise than any of us have on the practical effects of legislation.

The suggestion that Mr. Dikis made was also one of the several suggestions that Mr. Ainslie made. Let me ask Mr. Hamsher and Mr. Dikis if Mr. Ainslie's points are also the points that you would make. Do you agree with the suggestions and modifications that he has put to us?

Mr. HAMSHER. Let me say, on behalf of the city, that our position is that anything that can effectively continue to stimulate the reuse and rehabilitation of older or historic buildings is a very good thing for a city such as ours, and that there shouldn't be any kind of artificial barriers that I don't think were intended in the original ITC legislation, that would prohibit certain kinds of buildings from qualifying.

With respect to the requirement about 95 percent, from our perspective some lessening of that requirement would make very good sense, and perhaps it even could be considered for elimination.

With respect to the point made by the trust regarding the addition of portions of the external walls that have been added on to buildings over the years, which in fact is precisely the reason Union Station has some difficulties with the ITC, that the points the trust makes that are also well taken.

With respect to the additional items that the president of the trust addresses but which aren't addressed in your bill, Senator, frankly I am not an expert, and I am not here to testify about those issues.

Senator DANFORTH. Mr. Dikis.

Mr. DIKIS. Senator, thank you.

We, the American Institute of Architects, are very much in agreement with virtually all of Mr. Ainslie's comments, with one possible exception, and that would be the suggestion of the model for the test for the wall requirements being the Treasury regulation 1.191-2(e)(5), defining new construction for the replacement of the internal structural framework of a building, continuing our concern for that 95-percent rule.

We had firsthand experience within the past couple of weeks with an ongoing tax rehabilitation job in Des Moines where the structure was uncovered, and then we found that the wood joists were rotted beyond original anticipation and requiring replacement.

Senator DANFORTH. Well, gentlemen, thank you. We will take your advice under careful consideration. Of course, we have to try to keep Treasury on board as we are working with this bill, and their concern and our concern is that rehabilitation be rehabilitation, not knocking a building down and putting up a new building in the same place.

We will be working with you and appreciate your testimony.

Mr. DIKIS. Thank you, Senator.

Mr. HAMSHER. Thank you.

Mr. AINSLIE. Thank you.

Senator DANFORTH. The next bill is S. 1584: Mr. Lambrix, Mr. Carter, Mr. Barrese, Mr. Palmer, and Mr. Persky.

Mr. Lambrix.

STATEMENT OF ROBERT J. LAMBRIX, CORPORATE VICE PRESIDENT AND TREASURER, ARMCO, INC., MIDDLETOWN, OHIO, ACCOMPANIED BY ERNEST CHRISTIAN, JR., PATTON, BOGGS & BLOW, WASHINGTON, D.C.

Mr. **Lambrix**. Thank you, Mr. Chairman.

My name is Robert J. Lambrix. I am corporate vice president and treasurer for Armco, Inc. Accompanying me today is Mr. Ernest S. Christian, Jr., of the law firm of Patton, Boggs, & Blow.

I appreciate this opportunity to appear before this subcommittee to express Armco's strong support for S. 1584, the "Foreign Tax Credit Conformity Act of 1983." Each of the three amendments proposed in S. 1584 to the foreign tax credit rules—namely, creation of a domestic loss recapture rule, extension of the credit carryover to 15 years, and rearrangement of the ordering rules to a first-in-first-out basis—is both necessary and conceptually correct. We urge prompt enactment of S. 1584 this year.

Speaking first to the foreign tax credit limitation, I would like to review briefly with you the fundamental tax calculation which is relevant to the bill; namely, the annual foreign tax credit limitation.

This limitation basically is a simple ratio that calculates the maximum foreign tax credit for the year as an amount equal to the proportion of total U.S. tax liability. It is determined by the ratio of foreign source income to total worldwide income. This amount if further limited in that the maximum credit cannot exceed the amount of foreign taxes actually paid for the year.

The really important variable in the limitation is the numerator of the fraction, which is foreign source income. As that numerator rises and falls relative to worldwide income, the maximum foreign tax credit for the year also rises and falls.

Now, as for the first amendment, the proposed domestic loss recapture rule in S. 1584, which is also called the section 904(f) amendment, will correct a technical problem that arises under current limitation rules. It is a desirable policy change. Indeed, it is a necessary element of a foreign tax credit framework that considers a multiyear period rather than single years.

The artificial annual tax accounting period that the Internal Revenue Code imposes may be an administrative convenience, but it is not a realistic measuring stick of the income of ongoing businesses. Tax law has recognized the need to apply multiyear operating loss carryovers, investment credit carryovers, and foreign tax carryovers.

Of particular relevance to consideration of S. 1584 is the recognition of the multiyear principle that implicitly underlies the existing foreign loss recapture rule in section 904(f) as enacted in 1976.

The company that uses foreign losses to offset otherwise taxable U.S. income in one year, while claiming a foreign tax credit with respect to foreign income in the second year, should not, and in fact cannot, use the single year view of tax accounting to reduce U.S. taxes while maximizing the numerator of the credit limitation in the subsequent year. Congress and the Treasury recognize the need to measure foreign losses over a period of time in order to produce the correct cumulative result in the numerator of the limitation.

So the existing foreign loss recapture rule recharacterizes foreign income as domestic income for purposes of recapturing earlier foreign losses in the numerator.

Domestic losses produce the reverse or mirror-image effect. A company that in 1 year incurs domestic losses could offset foreign income, thereby creating carryover foreign tax credits, should not be subject to the single-year perspective of tax accounting in the second year.

The current approach increases U.S. tax while incorrectly minimizing the numerator of the credit limitation over time. The correct cumulative result over a multiyear period as proposed in S. 1584 is to recharacterized an amount of subsequent domestic income as foreign-source income for purposes of the numerator.

This domestic loss recapture rule contained in S. 1584 has been correct as a technical and conceptual matter for many years; but the severity of the domestic losses incurred during the recession now make it a financial imperative. The 1982 domestic losses for Armco and other companies offset foreign income which we continue to rely on as an important source of capital for domestic investments. If the technical problems with the cumulative numerator of the limitation are not corrected, there almost certainly will be an element of double taxation of foreign income.

Please understand that in supporting S. 1584 we are not coming before this subcommittee asking for some type of tax benefit or tax incentive; simply, we are asking not to be double taxed, a result which I believe everyone acknowledges will incur unless the technical amendment to recapture domestic losses is enacted.

I see that I have run over my time. I think the carryover period and ordering rule are adjustments that are perhaps better understood, and I will simply close by asking: Why not also enact the FIFO rule and the 15-year carryforward?

Both Mr. Christian and I would be pleased to answer your questions on the FIFO rule, the carryforward, and the domestic loss recapture rule. Thank you.

[The prepared statement of Robert J. Lambrix follows:]

STATEMENT OF

ROBERT J. LAMBRIX
CORPORATE VICE PRESIDENT AND TREASURER
ARMCO INC.

BEFORE

THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

September 26, 1983

"S. 1584--The Foreign Tax Credit Conformity Act of 1983"

Mr. Chairman, my name is Robert J. Lambrix. I am Corporate Vice President and Treasurer for Armco Inc. I am accompanied by Ernest S. Christian, Jr., of the law firm of Patton, Boggs & Blow.

I appreciate this opportunity to appear before this Subcommittee to express Armco's strong support for S. 1584, "The Foreign Tax Credit Conformity Act of 1983," introduced by Senator Danforth, Senator Bentsen and Senator Huddleston. Each of the three amendments proposed in S. 1584 to the foreign tax credit rules -- namely, creation of a domestic loss recapture rule, extension of the credit carryover period to 15 years, and rearrangement of the ordering rule to first-in-first-out (FIFO) -- is both conceptually correct and economically necessary. We urge the enactment of S. 1584 this year.

The Impact of the Recession on Armco

Armco often is identified as a steel company, and we are a major domestic producer of carbon steel. However, Armco also has five other business lines. For example, Armco engages in the manufacture and marketing of oilfield exploration and production equipment. A growing line of business for our company is the manufacture of aerospace and strategic materials. We also offer a broad range of financial and insurance services to industrial, commercial and personal markets in the U.S. and around the world. Specialty steels continue as one of our six business lines. Fabricated products and services are manufactured and provided for major capital projects and industrial services around the world.

Although we are a diversified company, Armco's strong ties to basic industries such as steel manufacturing and petroleum exploration led to very significant losses in our domestic operations in 1982. The continuing effects of recession are likely to produce another overall domestic loss for 1983, although we are anticipating a return to domestic profitability next year.

As a company with worldwide operations and income, the flow of funds back into the U.S. from our foreign subsidiaries has been, and will continue to be, an important source of capital for domestic investments to modernize our industrial plant and equipment. In lean domestic years, our overseas investments have generated income that was put to good use in the U.S. Even in

1982, with massive domestic losses, Armco was able to draw foreign-generated profits back into the U.S. to provide capital for our modernization program in steel and other sectors.

Foreign Tax Credit Issues Raised by Current Circumstances

However, the severity of the domestic losses in 1982 posed a significant financial dilemma for companies such as Armco that continue to bring home earnings on overseas investments. The foreign tax credit (FTC), which is intended to prevent double taxation of the same foreign income by both the U.S. and the foreign host country, does not currently take into account the effect of domestic losses that offset foreign source income in a given year. Furthermore, the FTC rules do not allow sufficient time or flexibility for a company to utilize credits which have been carried over as excess credits (i.e., that are unusable in the current year) due to domestic losses that offset foreign source income in an earlier year.

We continue to be forced to choose between (1) suspending the repatriation of foreign earnings in domestic loss years, or (2) accepting the ultimate loss of certain foreign tax credits, which would thereby impose a double tax penalty on foreign earnings over a period of years.

Until recently, the statutory provisions (and omissions) which have created the dilemma were of only very minor interest because they had a limited impact on taxpayers. The revisions proposed in S. 1584, which will correct the technical problems, were conceptually correct at the same time that related amendments to the FTC rules, the investment tax credit (ITC) rules, and the net operating loss (NOL) rules were adopted in prior years. However, the potential circumstances which gave rise to their current need were not considered at those times.

The conceptual justification continues, and the recession has brought about circumstances that create a substantial, urgent economic need for the revisions.

A Domestic Loss Recapture Rule

Many companies faced the combination of circumstances that Armco confronted in 1982 -- a substantial domestic loss that offset foreign source income in that year. If the domestic loss offset all such foreign income, then it prevented the company from utilizing any of the foreign tax credit associated with the taxes paid to foreign governments with respect to that foreign source income. These credits then become an "excess foreign tax credit carryover" that can be carried back 2 years or forward 5 years. Such carryover credits might be usable in such years if the company has sufficient "FTC limitation" in a carryover year to accommodate both that current year's FTC and the carryover credit.

Foreign Tax Credit Limitation

The FTC limitation is designed to allow foreign taxes paid on foreign source income to offset, i.e. to be a credit against, the U.S. tax liability on such income, while preventing foreign taxes from reducing U.S. taxes on U.S. income. The limitation achieves this result through a simple formula that uses a ratio of foreign source income over worldwide income to determine the proportionate amount of the U.S. tax liability that is attributable to the foreign source income. The result is the maximum amount of U.S. tax for that year that can be offset by foreign taxes. This amount is further limited to the actual amount of FTC available to the company in that year. Thus, if the formula allows $46 of U.S. tax to be offset this year but the company has only $40 of foreign tax credits (both current and carryover) available for the year, then the additional $6 must be paid as U.S. tax on foreign source income.

Algebraically, the FTC limitation formula is expressed as follows:

$$\text{FTC limitation} = \frac{\text{foreign source income}}{\text{worldwide income}} \times \text{U.S. tax on worldwide income}$$

Domestic Loss Companies

When companies with carryover credits due to domestic losses are paying foreign taxes at rates equal to the U.S. rate, the FTC limitation in carryover years will not allow the use of carryover credits because each later year's current FTC (which must be used first) will consume the full limitation. Consider the following situation.

EXAMPLE 1

	Year 1	Year 2	Year 3	Total
Domestic income	($100)	$ 0	$ 100	$ 0
Foreign source income	100	100	100	300
Worldwide income	0	100	200	300
46% U.S. tax (before FTC)	0	46	92	
46% foreign tax paid	46	46	46	138
FTC utilized	0	46	46	92
FTC carryover to succeeding year	[46]	[46]	[46]	
Net U.S. tax paid	0	0	46	46
Total tax paid	$ 46	$ 46	$ 92	$ 184

Over the 3-year period, the company has earned net worldwide income of $300. All of that income is attributable to foreign source income; net domestic source income is $0. Yet, the company pays net U.S. tax of $46 in addition to foreign taxes of $138. This occurs because the domestic loss in year 1 offsets $100 of foreign source income, and the 46 percent foreign rate prevents the FTC limitation from absorbing the carryover credit in a later year. The technical source of this problem is that the limitation, as currently structured, is unable to take into account in the ratio's numerator the $100 of foreign income that was offset in year 1.

The problem is made readily visible by computing the FTC limitations, based on the facts in EXAMPLE 1, both annually (as required by the Code) and cumulatively (which is not allowed).

	Ratio		U.S. Tax		FTC Limitation
Year 1	$\frac{100}{0}$	x	0	=	0
Year 2	$\frac{100}{100}$	x	46	=	46
Year 3	$\frac{100}{200}$	x	92	=	46
Actual 3-Year Cumulative	$\frac{200}{300}$	x	138	=	92
Correct 3-Year Cumulative	$\frac{300}{300}$	x	138	=	138

The domestic loss in year 1 has permanently offset the foreign source income in the numerator of the limitation. The cumulative computations illustrate the problem. The "Actual" computation drops $100 from the numerator; the "Correct" computation would take into account all $300 of foreign source income. The result over three years is that the lost $100 is taxed twice -- once in the foreign country and again in the U.S.

The problems with this result are obvious. First, it is contrary to the intended purpose of the FTC, which is to prevent double taxation. Second, it raises the need for company financial planners to consider suspending the repatriation of foreign earnings during domestic loss years, in order to avoid an undesirable tax penalty.

Proposed Solution

Domestic losses that offset foreign source income in the current year should be "recaptured" in later years. This means that an amount of future domestic income equal to the amount of the earlier domestic loss that offset foreign income would be recharacterized as foreign source income for purposes of the FTC limitation numerator. This would increase the numerator in a future year or years and allow carryover credits attributable to the earlier domestic loss to be utilized. Under such a rule, the circumstances in EXAMPLE 1 above would be restated to show the following:

EXAMPLE 2

(EXAMPLE 1 as restated under S. 1584)

	Year 1	Year 2	Year 3	Total
Domestic income	($100)	$ 0	$ 0	($100)
Foreign source income	100	100	200	400
Worldwide income	0	100	200	300
46% U.S. tax (before FTC)	0	46	92	
46% foreign tax paid	46	46	46	138
FTC utilized	0	46	92	138
FTC carryover to succeeding year	[46]	[46]	[0]	
Net U.S. tax paid	0	0	0	0
Total tax paid	$ 46	$ 46	$ 46	$ 138

After enactment of the domestic loss recapture rule, in year 3, the $100 of domestic income is treated as an additional $100 of foreign income. Thus, the company is able to make full use of its FTC carryover, when it returns to domestic profitability. Over the 3-year time period, the $300 of worldwide income is fully taxed at 46 percent. During the same period, the $0 net domestic income in EXAMPLE 1 does not generate the $46 U.S. tax that is added to the $138 foreign tax under EXAMPLE 1 because the foreign source income numerator in the ratio has taken into account in year 3 the $100 of foreign source income that was offset by the domestic loss in year 1.

Furthermore, for many affected taxpayers, enactment of the rule will relieve their need to undertake significant alterations in the timing of domestic income recognition and deductions (in order to avoid or minimize a domestic loss in advance) or other significant tax planning (to utilize carryover credits after the loss year).

"Mirror Image" of Existing Law

In addition to producing the appropriate financial result, the domestic loss recapture rule also will provide treatment for domestic losses in a manner parallel to, and consistent with, the current treatment of foreign losses in the FTC limitation calculation.

The 1976 Tax Reform Act added section 904(f) to the Code to recapture a prior-year foreign source loss against later-year foreign source income, by recharacterizing the latter as domestic source income solely for purposes of the FTC limitation calculation. This section 904(f) foreign loss recapture rule was enacted to prevent a taxpayer from deriving a double tax benefit from a foreign source loss. Prior to the 1976 Act, a foreign loss could offset domestic source income, thereby reducing U.S.

taxable income and U.S. tax liability. In subsequent years, profitable foreign operations would generate foreign source income that was accompanied by a foreign tax credit. Thus, the absence of the foreign loss recapture rule allowed a double tax benefit -- reduced U.S. taxes due to the foreign loss and a credit against U.S. taxes on subsequent foreign income.

In 1976, the double benefit was apparent, and taxpayers were receiving those benefits. But the mirror image, i.e., domestic losses that produce a potential double tax payment that benefits the federal government, was not considered at that time. Therefore, the parallel and consistent domestic loss recapture rule was not enacted.

By early this year, the domestic loss problem had become quite real. Many U.S. companies had incurred substantial losses while still returning their foreign earnings to the U.S. For this reason, the absence of the domestic loss recapture rule has passed from academic interest into a matter of significant financial concern. The domestic losses from the recession are seriously threatening to diminish the effectiveness of the FTC.

Therefore, for both economic and conceptual reasons, the domestic loss recapture rule in S. 1584 should be enacted promptly and made effective for domestic losses arising in 1982 and thereafter.

15-Year Carryover Period and FIFO Ordering Rule

The provisions of S. 1584 amend both the FTC carryover period rules and the FTC ordering rules. Although separate features of the law, the carryover and ordering rules are closely interrelated. The two are discussed together here.

Carryover Period

Companies incurring domestic losses under current law (and under the proposed domestic loss recapture rule) can carryback the resulting excess FTC to the 2 preceding years and then carry forward remaining amounts to the 5 succeeding years. This is a very short carryforward period in comparison to the 15 years allowed for both the ITC and NOLs, and it creates a serious potential for ultimately losing the carryover credits.

Ordering Rule

When the FTC is utilized in a given year, current law requires that the current year's credit be used first, followed by carryforwards from the preceeding 5 years, and then by carrybacks from the succeeding 2 years. This rule, in contrast to the FIFO rule applied to ITCs, diminishes rather than enhances the efficiency of the FTC as a mechanism to prevent double taxation.

Interactions Among FTC Rules and Other Tax Provisions

The foreign tax credit is intended to recognize the prior right of source countries to tax income earned therein, and it is structured to reduce or to offset U.S. tax liability on that income by the amount of such foreign tax. A taxpayer may have foreign source income and pay foreign taxes in a year when it has insufficient U.S. tax liability to absorb the credit for foreign taxes paid. When a later year produces U.S. taxable income from foreign sources, the earlier year's unused credit should -- and perhaps can -- be taken into account as a carryover credit to such year. But by placing such carryovers behind credits arising in the current year and by allowing only a 5-year carryover period, present law creates the risk that such credits will be lost. The risk is most acute for the taxpayer who sustains a very substantial NOL from domestic sources and who pays high foreign tax rates.

NOLs. To illustrate this interaction, consider the taxpayer who incurs very large NOLs in both 1982 and 1983 while realizing foreign source income that is accompanied by foreign tax credits. Under present law, the NOL can be carried back 3 years and then carried forward up to 15 years, or at the taxpayer's election, can be only carried forward up to 15 years. Thus, the taxpayer's NOL from 1982 could be carried back to 1979, 1980 and 1981, and the 1983 NOL could be carried back to 1980 and 1981. (1982 is already a loss year.) But the very substantial 1982 NOL creates a new problem by completely eliminating taxable income in both 1979 and 1980, thereby freeing up additional FTCs to be carried back for 2 years and then forward for 5 years.

For example, $10,000 of freed credits from 1979 due to the 1982 NOL carryback would become FTC carrybacks to 1977 and 1978 for possible use. But the ordering rule requires that credits arising in the current taxable year must be used prior to carryforwards from earlier years and to carrybacks from later years. Therefore, unless the taxpayer has a sizable unused FTC limitation in 1977 and 1978, the credit carryback from 1979 is not likely to be of much value. As a carryforward, the freed credits from 1979 begin the 5-year carryover period already in serious jeopardy of being lost. The NOL carrybacks which freed the 1979 credits have also eliminated taxable income in 1980 and severely curtailed or eliminated taxable income in 1981. This frees more credits from those years, and there is no unused limitation capability to absorb the carryover from 1979. Since 1982 and 1983 are already useless as FTC carryover years by virtue of the losses generated in such years, the 1979 credit carryover must go into 1984 with only that single year remaining in the 5-year carryover period. Again, presuming that taxable income exists in 1984, the taxpayer must have an amount of unused FTC limitation _after_ using its 1984 credits in order to absorb the carryover from 1979.

This taxpayer could elect to relinquish the 3-year NOL carryback in order to preserve the prior use of the 1979, 1980 and 1981 credits that have already been used. But the result of this election probably will merely be to delay the loss of some credits. The sizable NOL carryforward from 1982 and 1983 probably will eliminate tax liability in 1984, 1985 and possibly beyond, depending upon the unknown level of taxable income in those years in comparison to the NOL carryforward. Thus, a carryover credit resulting from the 1982 loss (assuming little or no benefit from the 2-year carryback period) is in its fourth year in 1986 and still must wait behind the credit arising in 1986. Thus, the foregone NOL carryback would be of questionable value.

High Foreign Rates. This NOL situation is worsened further for taxpayers whose foreign tax rates are comparable to the 46 percent U.S. corporate rate. In such cases, the taxpayer perennially pushes against the limitation leaving little, if any, room for the use of carrybacks or carryovers. In the illustration above, a taxpayer who has substantial NOLs, an accompanying large carryover credit, and foreign tax rates of 46 percent or higher cannot generate sufficient U.S. tax liability and credit limitation within the 5-year carryover period to absorb the unused credit.

This illustrates the conflict between the intended benefits of the election to take only the extended NOL carryforward period and the foreign tax credit rules. When the NOL election was enacted in the Tax Reform Act of 1976, it was noted that a reason for allowing the election to forego the 3-year NOL carryback was to reduce the potential for losing foreign tax credits.

> Because of the interaction of the net operating loss rules and other provisions of the

> Code, a net operating loss carryback can in some cases actually increase a taxpayer's aggregate tax liability over the nine-year carryback and carryover period. For example, if a taxpayer has a loss to be carried back and if in the carryback year the taxpayer had foreign source income which resulted in no U.S. tax liability because of foreign tax credits, the net operating loss carrybacks would merely displace the foreign source income and accompanying foreign tax credits without providing tax benefit.
>
> General Explanation of the Tax Reform Act of 1976, H.R. 10612, 94th Cong. P.L. 94-455, p. 189.

The current ordering rule and short carryover period, applied in conjunction with NOLs, continue to present the problem discussed in 1976. Thus, the ordering rule and 5-year carryover restrict the optimum utilization of the FTC by taxpayers who experience significant losses, particularly if they pay high foreign tax rates.

It has been suggested by some that the 15-year carryover period for the ITC is justified because the ITC is an "incentive," whereas the FTC is intended to avoid double taxation. Whether correct or not, that distinction is not pertinent to whether both the ITC and FTC should have 15-year carryover periods. Instead, the fundamental point is the interaction between NOLs (as made more significant by the enactment of ACRS) and the credits.

The carryover period for the ITC was, in 1981, extended to 15 years in order to assure that the value of ACRS not be diminished by the concomitant loss of ITCs that otherwise would be pushed out beyond the ITC carryover period. The same is true with respect to the FTC. To the extent that short-carryover FTCs are lost due to ACRS, the value of ACRS is diminished by that amount. It is inconsistent to have enacted ACRS and to have extended the NOL and ITC carryover periods for the stated purpose, while at the same time leaving the FTC carryover at 5 years. So long as that is the case, taxpayers are inappropriately put to the choice of full utilization of ACRS or loss of foreign tax credits, a dilemma which was not intended to arise.

Consistency with ITC and NOL Rules

Harmonizing various technical features of the Code is a simplification objective that is desirable to seek whenever possible. The proposed FIFO ordering rule and 15-year carryover period for the foreign tax credit in S. 1584 would achieve such harmony with similar rules for the ITC. This would remove a complicating disparity from the Code and contribute, however minimally, to simplification of the tax law.

Furthermore, the amendments would equalize the foreign tax credit and NOL carryover rules, providing further simplification and a better interaction between NOLs and FTC carryovers.

There is no reason why the foreign tax credit should be omitted and left to remain under the 1958-vintage 5-year carryover subject to a rule requiring the current year's credits to be used before credits carried over from a prior taxable year.

Originally, both the investment tax credit and the foreign tax credit had a 5-year carryover and the archaic LIFO-type ordering rule. The ITC has been modernized and so should the foreign tax credit. The present 15-year carryover period for the ITC and the FIFO ordering rule are the result of a series of amendments, primarily in 1976 and 1981, which reflected the growing recognition by this Committee and various tax policy analysts that the older, unduly restrictive carryover and ordering rules produced random and arbitrary distortions for taxpayers that are justified by policy.

The provisions of S. 1584 are amendments that are consistent with the policy purpose of the foreign tax credit and are in conformity with similar provisions of existing law. They have become economically important as well as conceptually correct. We know of no reason why they should not be adopted.

Therefore, we urge prompt approval of S. 1584.

STATEMENT OF BILLY CARTER, VICE PRESIDENT OF FINANCE, NELLO L. TEER CO., CHAIRMAN, TAX AND FISCAL AFFAIRS COMMITTEE, ASSOCIATED GENERAL CONTRACTORS OF AMERICA, WASHINGTON, D.C.

Mr. **Carter**. Good morning. My name is Billy R. Carter, vice president of finance of Nello L. Teer Co., an international construction company based in Durham, N.C.

I am pleased to testify today as chairman of the Tax and Fiscal Affairs Committee of the Associated General Contractors of America.

AGC members perform more than 50 percent of the foreign construction performed by American firms and over 80 percent of construction performed in the United States.

I am pleased to be able to testify in support of the Foreign Tax Credit Conformity Act of 1983, Senate 1584. We believe each of the provisions of S. 1584—a domestic loss recapture rule, extending carryover and carryback periods, and changing the ordering use of credits—are necessary to provide a solution to the double taxation problem concerning the U.S. international construction industry.

The domestic loss recapture rule in S. 1584 would allow domestic losses which offset foreign source income to be recaptured in later years when there are domestic gains.

Present law requires that foreign losses be recaptured to offset foreign gains, to prevent a possible double benefit of a foreign loss in 1 year and a credit in another year. However, there is no corresponding rule to recapture a domestic loss which has negated foreign income in a previous year. Without a corresponding domestic loss recapture rule to mirror the foreign loss recapture rule, taxpayers are consistently disadvantaged. They are required to pay taxes on their foreign source income without having a credit recognized for the amount of tax paid to other countries on that income.

The volume of construction in the United States has dropped dramatically in 1981 and 1982 after a period of steady decline starting in 1973. In order to offset the decrease in domestic projects over the last decade, many firms in the industry have turned to international markets. The top 400 firms in the industry have secured 30 percent of their work from oversea projects in recent years as the result of these trends. Many smaller firms are also looking to international markets for a source of volume and profits. Many of these firms will be faced with the double taxation on their foreign income if a domestic loss recapture rule is not added to the code.

AGC also supports the provisions of S. 1584 which would extend the carryover period for foreign tax credits to 15 years and change the use order to allow the oldest credit to be used first. We also suggest that the carryback provisions for the foreign tax credits be extended to 3 years from the proposed 2 years, to match the provisions of the Internal Revenue code applicable to the net operating loss and investment tax credit.

In present law, the combination of the limitation of the foreign tax credit carryback and carryover periods and the order of the use of credits often causes foreign tax credits to expire before they can be used. If a taxpayer has a significant domestic net operating loss, it can be carried back for 3 years and effectively eliminates the carryback of the unused foreign tax credit. The extended loss carryover period of 15 years can also result in an accumulation of unused credits in future years.

Present law requiring current year credits to be used first causes credits to expire before being used, and should be changed to conform to similar Code provisions by allowing the older credits to be used first.

Enactment of S. 1584, modified to allow a 3-year carryback, is a most necessary step for the American international construction industry. The Conformity Act will provide the needed equity in our tax system to avoid the double taxation of foreign earnings faced by the industry.

Thank you for this opportunity to testify.

[The prepared statement of Billy R. Carter follows:]

Testimony of
Billy R. Carter
Presented to
Finance Subcommittee on Taxation and Debt Management
United States Senate
on the Topic of
Foreign Tax Credits
September 26, 1983

AGC is:

* More than 32,000 firms including 8,500 of America's leading general contracting firms responsible for the employment of 3,400,000-plus employees;
* 112 chapters nationwide;
* More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities;
* Over $100 billion of construction annually.

Good morning, my name is Billy R. Carter, I am the Vice President of Finance of Nello L. Teer Company, a national and international construction company based in Durham, North Carolina. I am testifying today for the Associated General Contractors of America as Chairman of the Association's Tax and Fiscal Affairs Committee. AGC members perform more than 50 percent of the contract construction by American firms abroad and 80 percent of the contract construction in the United States. AGC members are responsible for the employment of 3,400,000 individuals as a result of these construction activities.

I am pleased to be able to testify today in support of the Foreign Tax Credit Conformity Act of 1983 (S. 1584). AGC believes that the provisions of S. 1584 are needed to avoid the international double taxation problem faced by many U.S. construction contractors resulting from the expiration of foreign tax credits corresponding to taxes paid but made unusable by overly restrictive foreign tax credit limitation rules. We believe each of the provisions of S. 1584 - a domestic loss recapture rule, extending carrying periods, and changing the ordering use of credits - are necessary to providing a solution to the international double taxation problem confronting the U.S. international construction industry.

The domestic loss recapture rule in S. 1584 would allow domestic losses which offset foreign source income to be recaptured in later years when there are domestic gains. Foreign source income in any year which is not offset by foreign tax credits cannot be carried back or forward although the credits themselves are eligible for a 2 year carryback and 5 year carry forward under present law. The practical effect of this restriction is to cause the credits to expire before they can be used because the amount of the foreign tax credit cannot exceed what the U.S. tax would be on the foreign source income. Present law requires that foreign losses be recaptured to offset foreign gains to prevent a possible double benefit of a foreign loss in one year and a credit in another year. However, there is no corresponding rule to recapture a domestic loss which has negated foreign income in a previous year. Without a corresponding domestic loss recapture rule to "mirror" the foreign loss recapture rule taxpayers are consistently disadvantaged. They are required to pay taxes on their foreign source income without having a credit recognized for the amount of tax paid on that income to other countries.

Recent trends in construction illustrate the need for this rule. Construction in the U.S. has dropped dramatically in 1981 and 1982 after a period of steady decline starting in 1973. In order to offset the decrease in domestic project awards over the last decade many firms in the industry have turned to international markets. The top 400 firms in the industry have secured 30 percent of their work from overseas projects in recent years as a result of these trends. Many of these firms will be faced with the double taxation of their foreign income if a domestic loss recapture rule is not added to the code. These firms will have paid foreign taxes on their international construction income but not be allowed to recognize a credit because domestic losses offset their foreign source income. When these firms have future domestic income the credit limitation rules will prevent them claiming credits for the taxes already paid since it is unlikely they will have sufficient excess foreign source income to absorb current credits and prior year credits.

AGC also supports the provisions of S. 1584 which would extend the carryover period for foreign tax credits to 15 years and change the use order of credits to allow the oldest credit to be used first. We also suggest that the carryback provisions for foreign tax credits be extended to three years back to match similar provisions of the Internal Revenue Code such as the net operating loss and investment tax credit provisions for carrybacks.

The combination of the foreign tax credit carryover periods and the credits' order of use often causes foreign tax credits to expire before they can be used. If a taxpayer has a significant net operating loss it can be carried back for three years and effectively eliminates the carryback of the unused foreign tax credit. If the taxpayer elects not to carryback the operating loss credits can be used, provided the other foreign tax credit limitation rules allow the use of the credit. However, electing not to carryback the operating loss further delays the availability of the foreign tax credits in the future. The extended operating loss carryover period of 15 years can also result in more unused credits in future years. Present law requiring current year credits to be used first also causes credits to expire before being useable and should be changed to conform to similar Code provisions by allowing the older credits to be used first.

Enactment of S. 1584 into law is a most necessary step for the American international construction industry. The Conformity Act will provide the needed equity in our international tax system to avoid the international double taxation faced by the industry.

STATEMENT OF PAUL A. BARRESE, DIRECTOR OF TAXES OF ASARCO INC., NEW YORK, N.Y., ON BEHALF OF TAX EXECUTIVES INSTITUTE, INC., ARLINGTON, VA., ACCOMPANIED BY THOMAS M. NEE, ASSISTANT TREASURER AND DIRECTOR OF TAXES, SCM CORP., NEW YORK, N.Y.

Mr. **Barrese**. Senator Danforth, I am director of taxes of ASARCO, Inc. in New York, and president of Tax Executives Institute, Inc. I appear today on behalf of TEI, a professional association of corporate and other business executives who are responsible for the tax affairs of their employers.

I am accompanied by Thomas M. Nee, assistant treasurer and director of taxes of SCM Corp., who is currently chairman of TEI's International Tax Committee.

Tax Executives Institute is the principal association of corporate tax executives in North America. Our 3,800 individual members work for more than 1,100 of the leading corporations of the United States and Canada. We appreciate the opportunity to appear before the subcommittee today and wish to express our unqualified support for S. 1584, which would effect significant and much needed reforms in the foreign tax credit area.

The principal purpose of the foreign tax credit provisions of the Internal Revenue Code is the avoidance of double taxation on income earned by U.S. persons. The current rules, however, produce some significant inequities and frequently fail to accomplish their intended results. For instance, under section 904(c) of the code, any credit not used against U.S. tax in the current year may be carried back only 2 years and forward only 5. If not utilized during these periods, the credit is lost.

In our view, the carryback/carryforward rules are unreasonably restrictive and result in double taxation. Indeed, the rules are out of step with the code's carryback and carryforward provisions relating to investment tax credits, targeted jobs credits, and research tax credits, as well as with the rules governing net operating loss carrybacks and carryforwards.

TEI also believes that the current rules relating to the foreign tax limitations, specifically section 904(f) of the code, should be repealed or, at a minimum, significantly revised. The limitation is a mechanism that essentially limits the foreign tax credit to an amount not exceeding what the U.S. tax would be on the taxpayer's foreign source income. Because of the inconsistent treatment of foreign source losses and domestic losses, however, the limitation frequently operates to defeat the very purpose of the foreign tax credit, the avoidance of double taxation.

Finally, we believe the ordering rules for the use of foreign tax credits should be modified to conform with those relating to net operating losses and other tax credits.

The foreign tax credit rules have a debilitating effect on business. In many cases, repatriation of millions of U.S. dollars is postponed because of foreign tax credit restraints. Moreover, companies with excess foreign tax credits, or with overall foreign or domestic losses, cannot, because of the provisions of section 904(f), economically expand their overseas sales. These companies are faced with prospective combined United States and foreign effective tax rates approaching and often exceeding 100 percent and are thereby precluded from doing business in foreign markets. Foreign-controlled companies clearly have a competitive advantage.

The inequities and harsh effects of current law could be ameliorated by promptly enacting S. 1584, the Foreign Tax Credit Conformity Act of 1983. The bill would establish a domestic source recapture rule under which domestic losses would be treated in the same manner foreign losses are now treated, with respect to offsetting other income.

In addition, the bill would lengthen the foreign tax credit carryover period to 15 years, thereby conforming the foreign tax credit provisions to those relating to net operating losses and other tax credits.

Finally, the bill would modify the current ordering rules relating to foreign tax credits, providing that the credits are to be used in the order earned—that is, on a FIFO basis.

Tax Executives Institute wholeheartedly supports S. 1584 and urges the subcommittee to act favorably on the bill.

We are submitting as part of our presentation appendix A, a detailed analysis of the need for conformity and symmetry in the foreign tax credit area. We respectfully request that the analysis which was submitted to the staff of the Joint Committee on Taxation and to the Treasury Department in January of this year be associated with this statement and included in the record of the subcommittee's hearing.

Although S. 1584 does not address all of the issues and problems discussed in appendix A, the bill would significantly ameliorate the harsh effects of current law. Consequently, Tax Executives Institute fully supports passage of S. 1584.

Mr. Nee and I would be pleased to answer any questions you may now have with a response, or any subcommittee requests for additional information.

Thank, you, Senator.

[The prepared statement of Paul A. Barrese follows:]

Statement

of

Paul A. Barrese
Director of Taxes
ASARCO Incoporated
New York, New York

on behalf of

TAX EXECUTIVES INSTITUTE, INC.

on

S. 1584, Foreign Tax Credit Conformity Act of 1983

before the

Subcommittee on Taxation and Debt Management
Committee on Finance
United States Senate

September 26, 1983

Mr. Chairman and Members of the Subcommittee: I am Director of Taxes of ASARCO Incoporated in New York and President of Tax Executives Institute, Inc. I appear today on behalf of TEI, a professional association of corporate and other business executives who are responsible for the tax affairs of their employers. I am accompanied by Thomas M. Nee, Assistant Treasurer and Director-Taxes of SCM Corporation, who is currently chairman of TEI's International Tax Committee. We shall confine our comments to S. 1584, the Foreign Tax Credit Conformity Act of 1983, which was introduced by Senators Danforth, Bentsen, and Huddleston.

Background

Tax Executives Institute is the principal association of corporate tax executives in North America. Our 3800 individual members work for more than 1100 of the leading corporations in the United States and Canada. No single industry dominates TEI. We truly represent a cross-section of the business community and believe our diversity and dedication to the tax function qualify us to address issues concerning the administration of the tax laws and the effective implementation of tax policy. TEI is dedicated to promoting the uniform and equitable enforcement of the tax laws throughout the nation and to reducing the costs and burdens of administration and compliance to the benefit of government and taxpayers alike. We appreciate the opportunity to appear before the Subcommittee today and wish to express our unqualified support for S. 1584, which would effect significant and much needed reforms in the foreign tax credit area.

The Need for Foreign Tax Credit Conformity

The principal purpose of the foreign tax credit provisions of the Internal Revenue Code is the avoidance of double taxation on income earned by U.S. persons. The current rules, however, produce some significant inequities and frequently fail to accomplish their intended result. For instance, under section 904(c) of the Code, any credit not used against U.S. tax in the current year may be carried back only two years and forward only five. If not utilized during these periods, the credit is lost.

In our view, the carryback/carryforward rules are unreasonably restrictive and result in double taxation. Indeed, the rules are out of step with the Code's carryback and carryforward provisions relating to investment tax credits, targeted jobs credits, and research tax credits, as well as with the rules governing net operating loss carrybacks and carryforwards.

TEI also believes that the current rules relating to the foreign tax credit "limitation" -- specifically, section 904(f) of the Code -- should be repealed or, at a minimum, significantly revised. The limitation is a mechanism that essentially limits the foreign tax credit to an amount not exceeding what the U.S. tax would be on the taxpayer's foreign-source income. Because of the inconsistent treatment of foreign-source losses and domestic losses, however, the limitation frequently operates to defeat the very purpose of the foreign tax credit -- the avoidance of double taxation.

Finally, we believe the ordering rules for the use of foreign tax credits should be modified to conform with those relating to net operating losses and other tax credits.

The Harsh Effects of Current Law

The current foreign tax credit rules have a debilitating effect on business. In many cases, repatriation of millions of

U.S. dollars is postponed because of foreign tax credit restraints. Moreover, companies with excess foreign tax credits or with overall foreign or domestic losses cannot, because of the provisions of section 904(f), economically expand their overseas sales. These companies are faced with prospective combined U.S. and foreign effective tax rates approaching and often exceeding 100 percent and are thereby precluded from doing business in foreign markets. Foreign-controlled companies clearly have a competitive advantage.

Proposed Solution: Prompt Enactment of S. 1584

The inequities and harsh effects of current law could be ameliorated by promptly enacting S. 1584, the Foreign Tax Credit Conformity Act of 1983. The bill would establish a domestic source "recapture" rule under which domestic losses would be treated in the same manner foreign losses are now treated with respect to offsetting other income. In addition, the bill would lengthen the foreign tax credit carryover period to 15 years, thereby conforming the foreign tax credit provisions to those relating to net operating losses and other tax credits. Finally, the bill would modify the current ordering rules relating to foreign tax credits, providing that the credits are to be used in the order earned (*i.e.*, on a FIFO basis).

Tax Executives Institute wholeheartedly supports S. 1584 and urges the Subcommittee to act favorably on the bill.

Detailed Analysis

We are submitting as part of our presentation Appendix A, a detailed analysis of the need for conformity and symmetry in the foreign tax credit area. We respectfully ask that the analysis, which was submitted to the staff of the Joint Committee on Taxation and the Treasury Department in January of this year, be associated with this statement and included in the record of the Subcommittee's hearing. Although S. 1584 does not address all the issues and problems discussed in Appendix A, the bill would significantly ameliorate the harsh effects of current law. Consequently, Tax Executives Institute fully supports passage of S. 1584. Mr. Nee and I would be pleased to answer any questions you may now have or to respond to any Subcommittee requests for additional information.

#

TAX EXECUTIVES INSTITUTE, INC.
January 13, 1983

APPENDIX A

THE NEED FOR FOREIGN TAX CREDIT CONFORMITY

Background

The United States was the first country to provide a credit on a worldwide basis against the federal income tax for the amount of income taxes paid foreign countries or U.S. possessions.[1] The purpose of the credit is simple: to prevent the double taxation of income earned by U.S. persons. U.S. persons are subject to federal income tax on their worldwide income whether it is earned in the U.S. or elsewhere.[2] In addition, practically all foreign countries also tax all income that is in some way effectively connected with their jurisdiction. Consequently, in the case of a U.S. person doing business overseas directly or through a foreign subsidiary, the resulting income will almost always be taxed twice. The foreign tax credit is designed to prevent this inequity.

The existing foreign tax credit rules, however, carry with them some rather significant inequities. For instance, under section 904(c), any credits not used against U.S. tax in the current year may be carried back only two years and forward only five. These rules are unreasonably restrictive and out-of-step with other provisions in the Internal Revenue Code. Moreover, through the vehicle of the foreign tax credit "limitation," the amount of the foreign tax credit cannot exceed what the U.S. tax would be on the taxpayer's foreign source income.[3] The existing rules for determining the amount of the "limitation" frequently result in double taxation -- thus defeating the very purpose of the foreign tax credit -- and should either be repealed outright or substantially modified. The following briefly reviews these issues and suggests appropriate remedial legislation.

---

[1] See generally E. Owens, The Foreign Tax Credit: A Study of the Credit for Foreign Taxes under United States Income Tax Law (1960). The foreign tax credit was originally enacted as part of the Revenue Act of 1918; the current provisions (I.R.C. §§ 901-08) were in large part contained in the Internal Revenue Code of 1954 as originally enacted.

[2] I.R.C. § 61(a).

Foreign Tax Credit Carryback/Carryover Rules

The foreign tax credit carryback/carryover provisions (two years back and five years forward) pale in comparison to the analogous rules in respect of the investment tax credit (section 46(b)) and net operating losses (section 172(b)); those rules provide for a three-year carryback and a fifteen-year carryforward. There is no readily explainable reason for the harsher rules in the foreign tax credit area. In fact, when each was originally enacted as part of the 1954 Code, the carryforward/carryback provisions in respect of net operating losses and the foreign tax credit were identical -- two years back and five years forward.[4] Although the rules have been liberalized several times for net operating losses (and investment tax credits) since 1954, the foreign tax credit provisions have, for no apparent reason, been substantially ignored.[5]

---

[3] I.R.C. § 904(a).

[4] I.R.C. §§ 172(b)(1) and 904(c), as originally enacted.

In addition, the ordering rules for foreign tax credits require that the current year's credits be utilized before any carryovers.[6] By contrast, in respect of the investment tax credit, a carryover is to be used first, before the current year's credits, to afford the taxpayer the maximum opportunity of using the credit.[7]

This lack of consistency and equity in the Code penalizes taxpayers who experience operating losses such that the government often reaps a windfall at the expense of distressed taxpayers. Consider, for example, a situation where a company is projecting net operating losses for both 1982 and 1983. These losses will be carried back to 1979 and 1980, respectively, possibly reducing taxable income in each of those years to zero. Because of the loss carrybacks to 1979 and 1980, the foreign tax credit attributable to taxes paid in those two years may be carried back two years and forward five. If there is no foreign tax credit limitation available in years prior to 1979, the only alternative is to carry the credits forward to 1984. This means that 1984 will be the only year available to absorb the 1979 credits and then only if there is still some part of the limitation available after absorbing any 1984 credits. Thus, in this example the 1979 credit carryover, triggered by a 1982 loss, must be absorbed in 1984 or double taxation of the 1979 foreign income will result.

---

[5] The Small Business Tax Revision Act of 1958 (Pub. L. No. 85-866) lengthened the NOL carryback period to three years and the NOL carryforward period to five years. The Tax Reform Act of 1976 extended the carryforward period to seven years. The Economic Recovery Act of 1981 increased the length of the NOL carryforward period to 15 years.

As originally enacted as part of the Revenue Act of 1982, investment credits could be carried back three years and carried forward five years. Pub. L. No. 89-800 (Nov. 6, 1966) extended the investment credit carryforward period to seven years. ERTA lengthened the carryforward period to 15 years.

[6] I.R.C. § 904(c).

[7] I.R.C. § 46(a)(1).

What often occurs under current rules, then, is that the government collects a substantial portion (if not all) of foreign tax credits previously earned and claimed because of the short carryback/carryforward period. Indeed, the lack of consistency in the foreign tax credit area effectively undermines the intent behind both the foreign tax credit and the NOL carryback/carryforward rules, for the net operating loss relief is reduced by the previously allowed foreign tax credits. The current foreign tax credit rules, therefore, place an even larger burden on a distressed company trying to recover from a loss position.

The present carryback/carryover rules can also adversely affect the cash flow from foreign subsidiaries. Specifically, a company's inability to utilize the foreign tax credits associated with dividends that would otherwise have been repatriated from foreign subsidiaries, in combination with the doubtful outlook for ultimate realization of the credits within the carryback/carryover period, might well lead the company to cancel dividends planned from these companies; it simply could not risk having the carryover period expire before the credit could be utilized. Such a result is especially troublesome where the company has short-term borrowings outstanding against which the cash dividends could be applied. In such a case, the cash generated by foreign subsidiaries would remain in foreign bank accounts to the benefit of the credit markets outside of the United States while the company was compelled to borrow additional funds in this country.

In addition, the failure to repatriate earnings from foreign subsidiaries impairs our country's balance of payments and encourages expansion overseas rather than in the United States. Thus, the present rules seem ill advised not only as a matter of tax planning but also from an economic policy standpoint.

Tax Executives Institute recommends that corrective action be taken to end these inconsistent and inequitable results. Specifically, section 904 of the Internal Revenue Code should be amended to provide a foreign tax credit carryback/carryover period that is identical with that allowed for net operating losses and investment tax credits (i.e., three years back and fifteen years forward). Second, the ordering rules for foreign tax credit purposes should parallel those for the investment credit: any carryover credit should be taken into account before the current year's credit. Finally, section 6411 should be amended to permit taxpayers to file an application for a tentative carryback adjustment in respect of a foreign tax credit carryback; there is absolutely no reason the "quickie" refund rules of the Code (which, of course, already apply in respect of investment credit and loss carrybacks) should not apply in respect of foreign tax credits.

Foreign Loss Recapture Rules -- Section 904(f)

The recapture rules of section 904(f) are deficient in several respects. Perhaps most significant, they lack symmetry in situations where foreign source income is offset by a domestic source loss. This could result in an unintended permanent loss of foreign tax credits with respect to the foreign taxes paid on the foreign source income, unless in subsequent years an equal amount of domestic source income is reclassified as foreign source income. The unfairness and illogic of such a result is best illustrated by the examples attached as Schedules A (and elaborated on in Schedule B). Example 1 in Schedule A illustrates the effect of section 904(f) in requiring the recharacterization of foreign income as domestic income to the extent of the prior overall foreign loss. Section 904(f), of course, provides for recapture of overall foreign losses and does not provide for similar recapture treatment when there is an overall domestic loss which is offset against foreign income in year one and in a subsequent year or years there is sufficient domestic income to otherwise absorb such overall domestic loss. Consequently, the credit can be lost where a taxpayer has an overall domestic loss and positive foreign income.

This unjustified result is illustrated by Example II in Schedule A. In year one the domestic loss offsets the foreign income and there is no net U.S. income tax liability. The excess foreign tax credit of $46,000 in year one is available as a carryback or carryforward under section 904(c). In year two foreign income is at the same level as in year one ($100,000) and foreign tax paid or accrued totals $46,000. Domestic income is $100,000 and the total U.S. taxable income equals $200,000. This results in a U.S. income tax liability of $92,000. With no recapture provisions for the prior year's overall domestic loss the section 904 limitation is equal to the ratio of foreign source income ($100,000) to total U.S. taxable income in year two ($200,000) multiplied by U.S. income tax before credit ($92,000), or $46,000. As a result, the taxpayer's net U.S. income tax liability in year two is $46,000. Since there is no net domestic income for the two-year period (therefore, no net U.S. tax should have been incurred), the pre-credit U.S. income tax ($92,000) for the two-year total foreign income ($200,000) should have been totally offset by $92,000 of foreign tax credit.

Thus, section 904(f) often operates to cause the very thing the foreign tax credit was intended to prevent -- double taxation. This, in turn, discourages companies from making investments that could benefit the U.S. economy as a whole. Tax Executives Institute believes that the inequities caused by the foreign tax credit limitation can best be eliminated by repealing section 904(f) outright. At a minimum, however, the harsh effects of the provision should be ameliorated by making several modifications in section 904(f). First, the overall loss provisions should be extended to apply equally to domestic loss situations to the extent the overall domestic loss offsets foreign source income in any year. In other words, the domestic loss recapture rule should become the mirror image of the foreign loss recapture rule. The effect of such a change is illustrated by Example III in Schedule A. In year two to the extent that the overall domestic loss from year one would otherwise have been absorbed against domestic income, such recapture of domestic loss should be reclassified as foreign source income consistent with the similar treatment afforded the recapture of foreign losses under section 904(f).

There is, moreover, a conflict between section 904(f) and section 1.861-8(e)(8) of the regulations that will lead to a double loss of foreign tax credits in situations where a taxpayer has a foreign source loss and an overall net operating loss. In such a case, when the net operating loss is carried back, the foreign portion of that loss will offset the foreign source income in the carryback year resulting in loss of tax credits in the carryback year. At the same time, section 904(f) requires that the overall foreign loss that was carried back under section 1.861-8 be recaptured against future foreign source income, again resulting in losses of foreign tax credits. This is hardly consistent with the policy of the foreign tax credit to avoid double taxation. To effectuate the purposes underlying the foreign tax credit provisions of the Code, section 904(f) should be modified so that the amount to be recaptured is reduced by the amount offset against foreign source income in the carryback year.

Under section 904(f)(1), the amount of overall foreign losses must be recaptured by reclassifying subsequent years' foreign source income as domestic source income. This reclassification effectively denies taxpayers the intended benefit of foreign tax credits. Under current law, the amount of income subject to reclassification in any one year is limited to 50 percent of the foreign source income for that year before reclassification.[8] This rule makes it extraordinarily difficult for a taxpayer in an overall foreign source loss position to use its foreign tax credits since current year's foreign source income is always first recaptured under section 904(f) thereby reducing the amount of limitation available for current years. If the overall foreign loss subject to recapture is sufficiently large (because, for example, of a foreign worthless stock or bad debt deduction), the taxpayer might be unable to utilize foreign tax credit for a number of future years.

Tax Executives Institute believes the time frame for recapturing overall foreign losses is over restrictive. We accordingly propose that overall foreign losses be treated in the same manner as domestic net operating losses, that is, over a fifteen-year period. In addition, to eliminate the harsh effects on the ability to absorb foreign tax credits in the year immediately subsequent to the overall loss year, we propose that the amount of foreign source income to be recaptured in any one year be changed from the present 50 percent of foreign source income before reclassification to 6-2/3 percent. The latter percentage corresponds to a pro rata recapture over the fifteen-year period. As in the current law, the taxpayer should also have a choice of recapturing more than the required amount in any given year.

---

[8] I.R.C. § 904(f)(1)(B).

SCHEDULE A
FOREIGN TAX CREDIT LIMITATION

	Example I *§904(f)—Foreign Loss Recapture*	*Foreign Tax*	*Example II* *Present Law—Domestic Loss*	*Foreign Tax*	*Example III* *Proposal—Domestic Loss Recapture*	*Foreign Tax*
YEAR 1						
Foreign Source Income	$(100,000)	$ —0—	$ 100,000	$46,000	$ 100,000	$ 46,000
Domestic Source Income	100,000		(100,000)		(100,000)	
U.S. Taxable Income	$ —0—		$ —0—		$ —0—	
U.S. Income Tax	$ —0—		$ —0—		$ —0—	
Allowable Foreign Tax Credit (Schedule B)	$ —0—	$ —0—	$ —0—	$ —0—	$ —0—	$ —0—
Excess Foreign Tax Credit (Year 1)		$ —0—		$46,000		$46,000
YEAR 2						
Foreign Source Income	$ 100,000	$46,000	$ 100,000	$46,000	$ 100,000	$ 46,000
Domestic Source Income	100,000		100,000		100,000	
U.S. Taxable Income	$ 200,000		$ 200,000		$ 200,000	
U.S. Income Tax	$ 92,000		$ 92,000		$ 92,000	
Allowable Foreign Tax Credit (Schedule B)	$ —0—	$ —0—	$ 46,000	$ 46,000	$ 92,000	$ 92,000
Excess Foreign Tax Credit (Limitation) (Year 2)		$ 46,000		$ —0—		$(46,000)
SUMMARY						
Foreign Source Income						
Year 1	$(100,000)		$ 100,000		$ 100,000	
Year 2	100,000		100,000		100,000	
	$ —0—		$ 200,000		$ 200,000	
U.S. Income Tax	$ 92,000		$ 92,000		$ 92,000	
Foreign Tax Credit	—0—		46,000		$ 92,000	
Net U.S. Income Tax	$ 92,000		$ 46,000		$ —0—	
Excess Creditable Foreign Tax	$ —0—		$ 46,000		$ —0—	

SCHEDULE B
FOREIGN TAX CREDIT LIMITATION

	I	II	III
YEAR 1	$\frac{\text{—0—}}{\text{—0—}} \times \text{—0—} = \text{—0—}$	$\frac{100,000}{\text{—0—}} \times \text{—0—} = \text{—0—}$	$\frac{100,000}{\text{—0—}} \times \text{—0—} = \text{—0—}$
YEAR 2	$\frac{100,000 - 100,000}{200,000} \times 92,000 = \text{—0—}$	$\frac{100,000}{200,000} \times 92,000 = 46,000$	$\frac{100,000 - 100,000}{200,000} \times 92,000 = 92,000$

STATEMENT OF JOHN F. PALMER, VICE PRESIDENT AND TAX COUNSEL, IC INDUSTRIES, INC., CHICAGO, ILL.

Mr. **Palmer**. Thank you, Senator Danforth.

My name is John Palmer. I am vice president and tax counsel of IC Industries, Inc., of Chicago.

IC appreciates the opportunity to testify in strong support of the Foreign Tax Credit Conformity Act of 1983, S. 1584. We urge the committee and the Senate to adopt this legislation this year.

The bill proposes three amendments to the foreign tax credit rules: a domestic loss recapture rule, a first-in, first-out [FIFO] ordering rule, and a 15-year carryover period. We support each of those three amendments. Each is correct and appropriate tax policy and should be adopted for both financial reasons and conceptual considerations.

The domestic loss recapture rule offers basic fairness in the foreign tax credit limitation over a period of years. What is proposed is a technical amendment to provide a treatment for domestic losses as a corrollary to the existing section 904(f) recapture for foreign losses. Other witnesses have discussed the nature of the problem in this area; let me just add a strong endorsement to what they have said.

A domestic loss recapture rule is necessary as a matter of policy to achieve the correct multiyear numerator in the foreign tax credit limitation, and it is necessary as a financial matter to companies that have incurred significant domestic losses during the recession while still bringing to the U.S. taxed foreign source income.

S. 1584 would also conform the treatment of unused foreign tax credit to the treatment of unused investment tax credits, other credits, and net operating losses. As indicated, unused foreign tax credits may under current law be carried back 2 years and forward 5; on the other hand, the investment tax credit, the targeted jobs credit, the alcohol fuel credit, the research activities credit, and net operating losses may be carried forward 15 years.

Congress in 1971 first recognized the merits of allowing an extended period for the carryover of the investment tax credit, which was finally made 15 years by the Economic Recovery Tax Act of 1981.

The recognition of an extended carryover period for tax credits, particularly the investment tax credit, has been consistent with the desired, equitable treatment for both marginal and substantial taxpayers encouraged by the tax laws to make new capital investment. Also, this recognition is consistent with the number of changes in the tax laws over the years affecting the benefit to the national economy from full enjoyment of the credit incentives.

The same can be stated for the now permitted election to carry net operating losses forward only, and thus forgo the carryback of such losses. This was permitted by the Congress so as not to impose a loss in the value of previously claimed foreign tax credits that are in a carryover status due to any carryback of operating losses. At the same time, it is unfortunate that the carryover period for the foreign tax credits was not extended as was the period for other credits. The recognition of the impact on investment credit usage by operating losses should dictate a similar concern for the relationship between operating losses and foreign tax credits.

There is no question that the limited 5-year carryover period, along with the rule requiring the usage of the current year's foreign tax credits before carryover credits, places taxpayers who are now experiencing domestic losses at considerable risk that their carryover credits will never be usable.

As to the ordering rule, finally, S. 1584 would conform the ordering rules for the foreign tax credit and other tax credits so that foreign tax credits will be used in the order earned.

Congress in a limited manner first modified the ordering rules for investment tax credits in 1971, and then changed to almost a pure FIFO rule in 1976. It was brought to the attention of Congress in 1976 that investment credit carryovers could not be used because of low levels of taxable income or net operating losses being incurred. Congress was concerned about the stimulative effect of the investment credit on new investments. As a result, the 1976 tax act changed the ordering scheme for using the investment tax credit to facilitate the use of carryover credits.

While the foreign tax credit is designed to offset U.S. tax liability on foreign source income so as to prevent excessive taxation, this objective is proving difficult to achieve with the limited carryover period of 5 years and the prevailing order of use rule.

The proposed changes will provide a desirable standardization for all tax credit usage rules, and, more importantly, some likelihood will be given that there will be proper usage of these credits, which is what we believe has always been intended.

Thank you, Mr. Chairman.

[The prepared statement of John F. Palmer follows:]

STATEMENT OF
JOHN F. PALMER
VICE PRESIDENT-TAX COUNSEL
IC INDUSTRIES, INC.
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE
ON S.1584
SEPTEMBER 26, 1983

Mr. Chairman, my name is John F. Palmer. I am Vice President-Tax Counsel of IC Industries, Inc. It is a pleasure for me to appear before this Subcommittee.

AMENDMENT TO SECTION 904(f)

I appear today in support of the enactment of S.1584, the Federal Tax Credit Conformity Act of 1983, which would correct the inequity and inconsistency in the Code contained in Section 904(f). This inequity results from the failure to recognize in Section 904(f) the need for a reciprocal provision requiring the recapture of domestic losses previously used against foreign source income in determining the foreign tax credit allowance such as Section 904(f) currently requires in the recapture of foreign losses which have offset U.S. source income.

Section 904(f) was added to the Code by the Tax Reform Act of 1976. H.R. 10612, 94th Cong., P.L. 94-455. As indicated, this section provides for the "recapture" of foreign losses. This means that to the extent that an overall foreign loss reduces the taxpayer's taxable income in a particular year, a portion of the foreign source income of the taxpayer in each succeeding taxable year is treated as income from within the United States for purposes of the foreign tax credit limitation formula. Section 904(f) attempts to make certain that in determining the Section 904 fraction for foreign tax limitation purposes the taxpayer has not been allowed over a period of time recognition of a foreign source income numerator in the fraction greater than his cumulative foreign source taxable income over the same period.

S.1584 would cover the reverse situation by requiring that domestic losses which previously had offset foreign source income be recharacterized (when in a subsequent taxable year domestic income is produced) as foreign source income for the foreign tax credit limitation to the extent the domestic losses earlier reduced the foreign tax credit available to the taxpayer.

There is basic fairness in the concept proposed by S.1584. This treatment was not adopted when Section 904(f) was enacted as part of the Tax Reform Act of 1976 apparently because of the inadvertent failure to anticipate the excessive tax burden on foreign source income which could result such as is being experienced by taxpayers in these times from marginal domestic taxable income or operating losses. What is proposed is a technical amendment to provide a corollary treatment for domestic losses as is done for foreign losses. Over a period of time, this amendment to Section 904(f) will assist in assuring that, for foreign tax credit limitation purposes, there will be proper recognition of taxpayers' foreign source taxable income.

The problem has been focused upon by those taxpayers which in the past few years have foreign source income on which foreign taxes have been paid but which income has been offset by domestic losses producing over a period of years a substantially higher, total effective tax rate solely because of the inability to use available foreign tax credits.*/ Excess foreign tax credits may be carried back two years and forward five. Moreover, current year foreign tax credits must be used before carried over credits. These limited rules serve to reduce the likelihood that excess foreign tax credit carryovers will be used by taxpayers now experiencing domestic tax losses.

In its efforts to improve productivity and promote the basic reindustrialization of the U.S. economy, Congress recently adopted in the Economic Recovery Tax Act of 1981 a new method for accelerating recovery of the costs of capital expenditures. In doing so, Congress was also concerned that the benefits of existing measures such as the investment tax credit to enhance national productivity and competitiveness not be diminished. This would occur if the investment tax credit were made unavailable for usage because of prior usage of the new cost recovery method. For this reason, Congress extended the period for usage of carried-over investment tax credits from seven to fifteen years to ensure the eventual usage of such credits as a continuing national policy to encourage capital investment and increased productivity.

---

*/Senator Danforth in his introduction of S.1584 illustrated this problem in his example showing a taxpayer's overall effective tax rate of 69 percent over a two-year period because of domestic losses offsetting foreign source income on which foreign taxes had been paid.

The lack of a mirror-image provision in Section 904(f) for the treatment of domestic losses produces the same deleterious consequences in the resulting diminished value of a U.S. taxpayer's foreign tax credits. We believe it certain that it was not intended to put taxpayers to a decision on whether to make capital investments subject to accelerated capital recovery or on the other hand to use available domestic or foreign tax credits. This unfortunate situation can be eliminated by the proposed amendment to Section 904(f) and the adoption of the important and necessary changes proposed by S.1584 in the ordering rules and the carryover period for the foreign tax credit.

The passage of S.1584 would in our opinion eliminate efforts of taxpayers facing potential loss of their foreign tax credits to produce low-tax foreign source income solely to attempt, but by no means, to ensure usage of their excess foreign tax credits. There would also be less exercise of the discretion available to taxpayers to adopt a slower dividend repatriation program to maximize foreign tax credit usage. Such a program might only serve to impact unfavorably the U.S. balance of payments and cause more domestic borrowing affecting U.S. interest rates.

As complex as the tax laws often seem, there is generally a symmetry present in most Code sections which is lacking in Section 904(f) and which S.1584 would with considerable justification cure.

CARRYOVER PERIOD AND ORDERING RULES AMENDMENTS

S.1584 would also conform the treatment of unused foreign tax credits to the treatment of unused investment tax credits, other credits, and net operating losses. Unused foreign tax credits may under current law be carried back two years and forward five. On the other hand, the investment tax credit, the targeted jobs credit, the alcohol fuel credit, the research activities credit, and net operating losses may be carried forward fifteen years. This extended carryover period of fifteen years is designed to assure usage of the specific credits. Congress in 1971 first recognized the merits of allowing an extended period for carryover of the investment tax credit which was finally made fifteen years by the Economic Recovery Tax Act of 1981. The extended carryover period for investment tax credits allows maximum use of the investment credit.

The recognition of an extended carryover period for tax credits, and particularly the investment tax credit, has been consistent with desired, equitable treatment for both marginal and substantial taxpayers encouraged by the tax laws to make new capital investment. Also, this recognition is consistent with the number of changes in the tax laws over years affecting the benefit to the national economy from full enjoyment of the credit incentives. The same can be stated for the now permitted election to carry net operating losses forward only and thus forego the carryback of such losses. This was permitted so as not to cause loss to the value of previously claimed foreign tax credits to be placed in a carryover status by any carryback of operating losses. At the same time, it is unfortunate that the carryover period for the foreign tax credits was not extended as was the period for other credits. The recognition of the impact on investment credit usage by operating losses should dictate a similar concern for the relationship between operating losses and foreign tax credits.

There is no question that the limited 5-year carryover period, along with the rule requiring the usage of current foreign tax credits before carryover credits, places taxpayers who are now experiencing domestic tax losses at considerable risk that their carryover credits will be made unavailable for usage.

S.1584 would also conform the "ordering" rules for the foreign tax credit to those for net operating losses and other tax credits so that foreign tax credits will be used in the order earned, i.e., on a first-in/first-out basis, rather than requiring the current year's credit be used before any carryover of credits.

Congress in a limited manner first modified the ordering rules for investment tax credits in 1971 but in 1976 changed to almost a pure FIFO system which is now in existence. In 1976, it was brought to the attention of Congress that substantial amounts of investment credit carryovers would not be used because of low levels of taxable income or net operating losses incurred. Congress was concerned that the desire of taxpayers to use existing tax credits as soon as possible would significantly dampen the stimulative effect of the investment credit on new investments. As a result, the 1976 tax act changed the ordering scheme for using investment tax credits to facilitate the use of carryover credits. General Explanation of the Tax Reform Act of 1976 - H.R.10612, 94th Cong., P.L.94-455, p.166.

While the foreign tax credit is designed to offset U.S. tax liability on foreign source income so as to prevent double taxation, this objective is proving difficult to achieve with the limited carryover period of five years for the foreign tax credit and the latter's prevailing order of use rule.

With little unfavorable impact on the revenues, the proposed changes in the carryover period and order of use rules for the foreign tax credit can be achieved producing a desirable standardization for all tax credit usage rules and, more importantly, some likelihood of the proper usage of these credits which is no more than what always has been intended. The effort to assure eventual use of investment credits as an incentive to an improved national economy, and also the elimination, as proposed by S.1584, of excessive taxation are equally important national objectives.

I thank the Subcommittee for its attention and request that our written statement be included in the record.

# # # # #

STATEMENT OF TOM E. PERSKY, DIRECTOR OF TAX POLICY, NATIONAL FOREIGN TRADE COUNCIL, WASHINGTON, D.C.

Mr. PERSKY. Thank you, Mr. Chairman.

I am Tom Persky. I am the director of tax policy with the National Foreign Trade Council. The Council represents more than 600 firms engaged in international commerce.

As you know, the U.S. taxes the worldwide income of its citizens and corporations, and it has adopted the foreign tax credit mechanism as a method to reduce or eliminate international double taxation.

When the foreign tax credit works correctly, U.S. taxpayers will pay the higher of the U.S. tax or the foreign tax on their foreign source income. Other countries have adopted other methods of dealing with international double taxation. In particular, some countries generally do not tax foreign source income of their citizens at all, which is known as the territorial system.

The foreign tax credit is not now operating correctly. Instead of paying the higher of the two taxes, the United States or the foreign tax, many taxpayers are now finding themselves paying both the United States and the foreign tax. This result flows from the foreign tax credit limitation that the other speakers have talked about, and in particular from the interaction of the foreign tax credit limitation and domestic losses.

The purpose of the foreign tax credit limitation is to make sure that the foreign tax credit is available only to offset U.S. tax on foreign source income. This limitation has been calculated a number of ways over the years, and the way it is calculated now is in our written statement and also in Treasury's statement.

Rather than get into the technicalities I would like to talk about what happens under current law.

The most important result that we see is that U.S. companies operating abroad are now taxed at higher rates than their foreign competitors. In our written statement, we show the example of a U.S. company's tax rate going from what should be a 46-percent rate to a 69-percent rate. We don't think that U.S. companies can compete at the international level when they are paying tax rates much, much higher than their competitors. We think that that has tremendous trade effects, and in our present trade situation we should be watching out for all of the trade effects we can see.

The second result that we see here is that this technical deficiency affects only companies with domestic losses. In fact, it affects those companies who are least able to deal with the problem.

One company that is profitable in the United States and overseas will find that it will not pay an international double tax; whereas, a company that is operating in the United States experiencing a loss in 1 year, because of the recession or something else, finds that it is going to be faced with international double taxation.

With regard to the carryback and carryforward provisions in the bill, we think that the existing provisions in the law are simply too short. Many companies find that they are unable to use foreign tax credits in the time period allowed.

Finally, I would like to comment on Treasury's position. I was here when Treasury testified on S. 1584, and it is my understanding that they are inclined to support this legislation but for revenue implications that they mentioned. While I think that the revenue implications are important—we should all be concerned with the deficit and Treasury revenues—, in this instance, if the revenue loss is large, that large revenue loss is the measure of the current double tax penalty that companies are paying. It's the measure of the competitive disadvantage that U.S. companies that have experienced losses have with their U.S. competitors; it's the measure of the competitive disadvantage that U.S. companies have with their foreign competitors.

I don't mean to be facetious about this, but this is almost as if you are refusing to give disaster relief because the disaster is large. It is our feeling that the Congress should address this problem at the earliest opportunity.

Thank you, Senator.

[The prepared statement of Tom E. Persky follows:]

STATEMENT OF
TOM E. PERSKY
DIRECTOR OF TAX POLICY
NATIONAL FOREIGN TRADE COUNCIL, INC.
ON S. 1584
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE

SEPTEMBER 26, 1983

The National Foreign Trade Council appreciates the opportunity to present its views on S. 1504, "The Foreign Tax Credit Conformity Act of 1983." The Council is comprised of more than 600 member companies engaged in international commerce, and the mechanics of the foreign tax credit are of crucial significance for the international and export operations of these firms. The Council supports S. 1584 which would correct a technical deficiency of the existing foreign tax credit provisions, and would make the foreign tax credit's very restrictive carryback, carryforward and "stacking" provisions uniform with the more liberal investment tax credit and net operating loss rules.

The Foreign Tax Credit

The foreign tax credit provisions of the Internal Revenue Code are designed to reduce international double taxation. Absent such a mechanism, the overlapping tax jurisdictions of nations would impose an unacceptable burden on international commerce.

The United States allows a dollar-for-dollar credit for foreign income taxes paid on income earned abroad. The use of the credit system assures that a U.S. person will pay the higher of the U.S. or foreign tax on income from abroad. Many countries, including Canada, Germany, Japan and the U.K., use a credit system to minimize double taxation. Other countries, including France, the Netherlands and Belgium, avoid double taxation by generally exempting foreign source income from tax.

Since the foreign tax credit is intended to reduce double taxation of income earned abroad, the system is designed to offset only taxes imposed with respect to foreign source income. The foreign tax credit cannot be used to reduce tax on U.S. source income.

The Overall Limitation

In order to prevent foreign tax credits from offsetting U.S. taxes on U.S. source income, a limitation--known as the "overall" limitation--is applied.[1] Under the provisions of sec. 904 of the Internal Revenue Code, the total amount of foreign tax credit that may be claimed cannot exceed a taxpayer's U.S. tax liability on its aggregate foreign source taxable income.

Foreign tax credits in excess of the limitation cannot be used to offset U.S. tax liability. However, these "excess credits" may be carried back two years or forward five years. In other words, if the use of the credit in one of these earlier or later years does not exceed the limitation calculated for those years, then the credits may be used to reduce the U.S. tax liability on the foreign source income of those years. Credits that are carried back or forward can be used only after currently earned foreign tax credits are used.

Section 904(f)

In the Tax Reform Act of 1976 the Congress amended the foreign tax credit limitation to deal with certain aspects of foreign losses. Prior to the change, a loss on foreign operations could act to reduce U.S. tax liability in one year and the foreign tax credit provisions could shield from tax the income generated in succeeding years. The solution of sec. 904(f) is to change the character of the income of those future years from foreign source to U.S. source. Because the foreign tax credit does not affect the tax on U.S. source income, the foreign tax credit cannot offset the tax on the newly recharacterized U.S. source income. By recharacterizing an amount of income equal to the original foreign loss, the tax reduction that flowed from the loss is "paid back."

Unfortunately, the Congress failed to deal with the the other side of the coin, i.e., the effects of domestic losses on the foreign tax credit limitation. Much like a foreign loss, a domestic loss can distort the proper operation of the credit.

The example provided in Senator Danforth's June 24 Congressional Record floor statement provides an excellent illustration of the effects of a domestic loss on a taxpayer's foreign tax credit position. In that example a company had $100 of foreign source income and a $100 domestic loss in the first year. The company had $100 of foreign income and $100 of domestic income in the second year. The foreign tax rate is assumed to be 46 percent. The company's total U.S. income for year one is zero ($100 income minus $100 loss). A $46 tax is paid in the foreign country and the $46 foreign tax credit is carried forward because there is no U.S. tax liability against which it can be applied. In year two the income is $200. The pre-foreign tax credit U.S. tax liability is $92 under present law. The foreign tax credit limitation for year two is $46.[2]

The net result of these transactions is the payment of $138 of tax on $200 of income. The effective rate of tax on this company's income is not 46 percent, but 69 percent.[3]

This result is devastating to international firms that compete with local enterprises. If the same operating results were achieved by separate local companies, the following tax results would occur.

	U.S. Company in U.S.	Foreign Company Overseas
Year 1 Income	($100)	$100
Tax	-0-	46
Year 2 Income	100	100
Tax	-0-	46
Total Tax	-0-	92

As you can see, the total tax paid by both companies is $92 instead of the $138 paid by the U.S. based multinational.

Further, this additional tax burden can result from minor timing differences. Consider, for example, the result if all the transactions in Senator Danforth's example took place in one year instead of two years.

U.S. Source Income	-0-	($100 gain minus $100 loss)
Foreign Source Income	$200	($100 gain plus $100 gain)
Pre-Credit U.S. Tax	92	
Allowable Foreign Tax Credit	92	(see footnote 4)
U.S. Tax	-0-	
Total Tax	96	

While carryback/carryforward periods are intended to resolve this kind of timing problem, the current structure of sec. 904(f) does not allow that result.

The solution to this problem is presented in S. 1584. The bill would "mirror" the foreign loss provisions of sec. 904(f) by recharacterizing an appropriate amount of domestic income as foreign source income. In the above example the $100 domestic income in year two could be recharacterized as foreign source income. That recharacterization would change the calculation of the foreign tax credit limitation so as to allow $92 of foreign tax credit to be applied to the $92 tax liability.

If current treatment of domestic losses is allowed to persist, the tax law will have the perverse effect of penalizing those companies least able to suffer the penalty. Present law treatment of domestic losses imposes a double penalty only on those companies that suffer a domestic loss. In other words, profitable U.S. companies get full protection from international double taxation, but companies that have lost money in the recent recession do not get the same protection. This anomalous result should be corrected.

It is important to note that after the recharacterization of the amount of the prior domestic loss, the total tax paid by the U.S. based multinational would be equal to the total tax paid by the two separate companies with the same operating results. The same amount of tax would be paid to the same tax authority, and the competitive balance would be restored.

The NFTC considers S. 1584's suggested changes to the foreign tax credit rules as essentially a technical correction. While it is true that some revenue loss will be associated with this change, that revenue loss is only the measure of the current technical deficiency.

Carryback/Carryforward and Stacking

The existing foreign tax credit carryback/carryforward and stacking rules are unnecessarily restrictive. A far more acceptable period for the use of these tax attributes is found in the investment credit and net operating loss rules. Those rules provide a 3-year carryback and 15-year carryforward. In addition, under these provisions, the older expiring benefits are used first, thereby extending the life of the tax benefits.

For a variety of reasons, including the domestic losses that resulted from the recent recession, a large number of companies are facing the expiration of "excess" credits. An extension of the carryback/carryforward periods and the reform of the stacking rules could prevent the immediate loss of these tax benefits. Without significant changes, taxpayers may be motivated to make inefficient tax dominated investment decisions. These efforts would be designed to use up these foreign tax credits before they expire. The result might be premature or delayed dividend payments, untimely acquisition or disposition of assets, or other transactions. An extension of the carryback/carryforward provisions would lessen the pressure for these actions.

Conclusion

The existing treatment of domestic losses in the calculation of the foreign tax credit limitation fails to fulfill the credit's purpose in eliminating international double taxation. The result is to place U.S. based companies with domestic losses at an additional competitive disadvantage. Further, the very short carryback/carryforward periods for "excess" credits tend to undermine the usefullness of the credit and may distort taxpayers' investment decisions. S. 1584 addresses both these problems and should receive the support of the Finance Committee and the Congress.

Notes:

1) At various times in its history the foreign tax credit limitation has over the years been calculated under the "overall" or "per-country" methods. The "overall" limitation is computed by multiplying pre-credit U.S. tax liability by a fraction, the numerator of which is total foreign income and the denominator of which is worldwide income. The effect is to allow pooling of foreign taxes and foreign income. Under the per-country method, a similar calculation is made on a country-by-country basis. For certain types of income, pricipally related to petroleum activities, these credits are further restricted. Such further limitation is not relevant to S. 1584.

2) $\frac{\text{Foreign Income}}{\text{Worldwide Income}} \times \text{Pre-Credit Tax}$

$\frac{\$100}{\$200} \times \$92 = \$46$

3) Under these facts the taxpayer does earn a $46 "excess credit." The 69 percent effective rate may be reduced to the extent that such credits are ultimately used.

4) $\frac{\$200}{\$200} \times \$92 = \$92$

Senator **Danforth**. Thank you very much.

Let me just ask one question. I don't necessarily want everybody to answer but, if you could, just give some examples.

What industry in the United States would be most helped if S. 1584 were to become law? And why?

Mr. **Barrese**. The capital-intensive industries certainly, Senator. You mentioned U.S. Steel before. I'm with ASARCO Inc. We're a mining company. We have operations abroad on which we are paying effective taxes of as high as 68 percent—in Peru, for example. Because of section 904(f), however, we have been unable to utilize the credit for these taxes. Our foreign tax credit is expiring.

Mr. **Carter**. I would certainly say that the construction industry would be hurt to the extent that any size company is working in the foreign markets, because frequently the foreign tax provisions or the tax codes are not set up to provide for tax accounting for construction; they are set up on an accrual accounting or cash-basis accounting. And a contractor may be paying foreign taxes on a project that would last 4 or 5 years—3 to 5 years—and he would not have foreign source income to be reported for U.S. tax purposes until he completes the project. And on that kind of a basis, his foreign tax credit would expire before he ever finished the project and reported that project for domestic purposes.

Mr. **Palmer**. Senator, may I just add to that?

Senator **Danforth**. Yes.

Mr. **Palmer**. One of our major companies is Abex Corp. We are highly diversified, but just to tick off a few things that we do: We are involved in friction braking materials and other accessory material for automotive and off-the-road equipment applications, specialty castings for the steel, nuclear power, food processing, contruction, mining, petrochemical and defense industries; we manufacture aerospace and robotics components. That shows how we might be affected by the present law which affects the capital-intensive industries.

Mr. **Lambrix**. Mr. Chairman, may I add to your question, an answer to your question? I would summarize it, based on my experience, that it's the basic capital-intensive U.S. industries. Although I represent basically a steel company, I think it could be expanded to that general category of our basic capital-intensive, traditionally—and I emphasize traditionally—very strongly competitive industries on a worldwide basis, which have lost in recent years some of their competitiveness.

Senator **Danforth**. Gentlemen, thank you very much.

Let me tell you what I think you could do that would help us very much. I think if you could furnish the committee with some examples of how the present situation is a disadvantage to specific industries. This is a highly technical area. But really I think the question that we and the Congress have is, Who is being hurt now? How is he being hurt? Why? And how would this help?

If you could give us some examples from your experience, and if you could particularly address yourself to something that I thought was fascinating, and that was that, while Treasury testified that the present law does not place a double tax on industry, you say that that's not correct. You have examples, I take it, of double taxation.

I think it would be very helpful if you could provide for the record some of those examples. In other words, if it is true that this bill would help some major industries which are having trouble in the United States and which are being successful abroad or have the potential of success abroad, I think that that kind of flushing out, making real what the situation is would be of enormous help to this committee. And especially if you could provide examples to go right to Treasury's point, namely "this is a question of averting double taxation," that would be of enormous help to us. So if you could just supply that for the record, that would be very helpful.

Mr. CARTER. Senator, could I just comment very briefly about Mr. Pearlman's example this morning?

Senator DANFORTH. Yes.

Mr. CARTER. He contended that because the tax in the second year was $92 on a $200 profit, and they gave credit for the foreign tax credit in that year, so the taxpayer only paid U.S. taxes of $46, there was no double taxation. But when you take the 2 years and you look at his example closely, the taxpayer actually paid $138 tax on $200 profit over a 2-year period—that's 69-percent tax—and there's a double tax in there somewhere.

Senator DANFORTH. All right. I think what we are going to have to do is to really spell that out. This is a bill which has strenuous opposition from the administration, because they view it as a revenue loser.

We have a $200 billion deficit, as you know, and some of us feel that we are not doing nearly enough to close that deficit. So if we have a revenue loser, we really have a fight on our hands.

I think that the way to make the point, and the only way to make the argument, is to say:

> All right, here are the specifics, how we are being hurt. Here are some examples of industries that are hurt. Here are some examples of industries that are being taxed twice, contrary to what the law intended.

And I think that it is possible to prevail on the Congress, but we are really going to have to get beyond technical arguments to the real-life situation if we are going to have a chance of prevailing. And you could very much help us to provide those examples.

[The following was submitted by AGC on October 14, 1983:]

ILLUSTRATION OF IMPACT OF DOMESTIC LOSSES ON FOREIGN TAX CREDIT LIMITATION

($000)

ABC Company (ABC) is a heavy construction firm that typically earns approximately one-third of its income from foreign projects. ABC normally has $30,000 of foreign and $60,000 of domestic source taxable income; however, in 1983, ABC incurs a $5,000 domestic loss. For the years 1983-1988, ABC has the following tax position:

	($000)	
	1983	1984-1988 (per annum)
Taxable Income		
Domestic Source	$(5,000)	$60,000
Foreign Source	30,000	30,000
Total U.S. Taxable Income	$25,000	$90,000
U.S. Tax (before credits) (46%)	$11,500	$41,400
Foreign Tax (46%)	$13,800	$13,800

It is assumed that:

(a) The current foreign tax credit (FTC) carryover periods apply (a two year carryback and a five year carryforward).

(b) No excess foreign tax credit limitation (Section 904 limitation) amounts are available to ABC in the two year carryback period.

Exhibit 1 illustrates the impact of the domestic loss on ABC's FTC position under current law (without a domestic loss recapture provision). As a result of the domestic loss in 1983, ABC is unable to utilize $2,300 of FTC. Therefore, in 1983 ABC pays combined U.S. and foreign taxes of $13,800 on U.S. taxable income of $25,000 (an effective rate of 55.2%). Thus, under the existing rules, ABC will never be able to reverse this inequity unless it can generate excess FTC limitation amounts during the carryover period. It is not unreasonable to assume that ABC will not be able to generate excess limitation amounts, since it is very difficult to do so. The reason for this is that the nominal corporate tax rate in many foreign countries is greater than 46%. The effective foreign tax rate is typically higher than the nominal rate because of U.S. expenses disallowed by the foreign jurisdiction's tax rules and the allocation of overhead expenses required by Treasury Regulation Section 1.861-8. Excess limitation amounts can be created in a carryover year only if the effective foreign tax rate is less than 46%.

Exhibit 2 shows how a domestic loss recapture provision would permit ABC to utilize in 1984 the excess FTC generated because of the domestic loss in 1983. This relief provision permits ABC no preferential benefit or advantage. The result is simply that ABC is permitted to pay combined U.S. and foreign taxes at an effective rate of 46% on its 1983 taxable income (when the FTC carryover to 1984 is considered).

ABC
FOREIGN TAX CREDIT UTILIZATION
WITHOUT DOMESTIC LOSS RECAPTURE
$(000)

	1983	1984-1988 (per annum)
(a) Section 904 limitation		
Foreign Source Income	$30,000	$30,000
Total U.S. Taxable Income	÷ 25,000	÷ 90,000
	100%	33-1/3%
U.S. Tax Liability	x 11,500	x 41,400
Limitation	$11,500	$13,800
(b) U.S. Tax Liability (before FTC)	$11,500	$41,400
(c) Foreign Taxes		
Current Year	13,800	13,800
Carryforward		2,300
Total	$13,800	$16,100
(d) Foreign tax credit (lesser of (a), (c))	$11,500	$13,800
(e) Net U.S. tax liability ((b) less (d))	$ -0-	$27,600
(f) Unused foreign tax Credits ((c) less (d))	$2,300	$2,300

EXHIBIT 1

ABC
FOREIGN TAX CREDIT UTILIZATION WITH DOMESTIC LOSS RECAPTURE
$(000)

	1983	1984	1985-1988 (per annum)
(a) Section 904 Limitation			
Foreign Source Income	$30,000	$35,000(a)	$30,000
Total U.S. Taxable Income	÷ 25,000	÷ 90,000	÷ 90,000
	100%	38.9%	33.3%
U.S. Tax Liability	x 11,500	x 41,400	x 41,400
Limitation	11,500	16,100	13,800
(b) U.S. Tax Liability (before FTC)	11,500	41,400	41,400
(c) Foreign Taxes			
Current Year	13,800	13,800	13,800
Carryforward	-0-	2,300	-0-
Total	13,800	16,100	13,800
(d) Foreign Tax Credit (lesser of (a), (c))	11,500	16,100	13,800
(e) Net U.S. Tax Liability ((b) less (d))	-0-	25,300	27,600
(f) Unused Foreign Tax Credit Amount ((b) less (d))	$ 2,300	$ -0-	$ -0-

Notes:

(a) Foreign Source Income (1984)	$30,000
Domestic Loss Recapture (from 1983)	5,000
Total For. Source Income	$35,000

Thank you very much.

The next bill is S. 1826, Mr. Ewing and Ms. Allen.

Mr. Ewing.

STATEMENT OF WILLIAM EWING, NATIONAL DIRECTOR OF MARKETING, SECOND HARVEST, PHOENIX, ARIZ.

Mr. EWING. Thank you, Mr. Chairman.

My name is Bill Ewing, and in my capacity as director of Marketing I represent Second Harvest, the National Foodbank Network, comprising 62 major foodbank distribution centers throughout the United States. Our major mission is soliciting donations of edible but surplus food from the Nation's food industry for distribution to local charities that serve the poor. In 1983 the Second Harvest Network expects to redistribute 100 million pounds of food donated by the private sector. Therefore, we have immense interest in the proposed legislation.

We enthusiastically endorse the committee's efforts to broaden both the eligibility of all retailers, wholesalers, and growers, and the tax deduction benefit available to those potential donors. This benefit is now limited only to non-subchapter S corporations. We believe eliminating this inequity will significantly enhance our efforts to expand the participation of certain segments of the food industry and increase the volume of their donations. Currently, only a small percentage of farmers donate to foodbanks. A tax incentive will greatly increase the amount of nutritious produce available for distribution to the needy.

As we deal with the large volume of donated food that we now locate throughout the country each day, the cost of transportation becomes an issue of increasing importance. We are most appreciative of the transportation services that certain rail and trucking companies have donated to us. We believe the opportunities provided by this bill will greatly improve our abilities to broaden our working relationship with all members of the transportation industry. Since transportation costs generally represent 15 percent of a foodbank's operating budget, the donation of these services will allow the foodbanks to allocate resources into other pressing areas, such as improved warehouse facilities and equipment.

Foodbanks are membership organizations made up of private nonprofit feeding programs. We have long been concerned with legislation that bars certain governmental organizations from membership. Generally, these would be units that provide services to those in crisis situations or rehabilitative care to the needy. We are troubled with that portion of this bill that will permit larger programs such as schools, hospitals, et cetera, with existing food budgets to receive donated food. We recommend that further study be given to the types of Government programs that would be allowed to receive this food so that:

One, resources are not drained away from private programs;

Two, this legislation will not allow donated food to replace food provided as a principal function by such governmental agencies as prisons and schools;

Three, current funding for social welfare programs not be jeopardized; and

Four, certain specific governmental programs be allowed to enhance and improve their care of the needy, especially in emergency situations.

Referring to page 4, section 4, we recommend the substitution of the appropriate section of the current law, with one modification, as follows:

> Notwithstanding any other provision, a contribution will not qualify under this section if the donee organization or any transferee of the donee organization requires or requests any money, property, or services for the transfer or use of the property contributed under section 170(e)(3).

We are strongly opposed to the concept of passing even minimal costs along to the ultimate receiver of this food. Our experience shows that some recipients wish to voluntarily contribute for donated food. The language we are proposing would not preclude this, but it would prohibit any organization from requesting or requiring a donation from a recipient.

We sincerely applaud the goals of this bill, which will increase the amount of donated food available for nonprofit feeding organizations, reduce certain foodbank costs, and promote a strengthening of the relationship between the private sector and the charitable community.

On behalf of Second Harvest food banks throughout the United States, we thank you for your efforts and for this opportunity to make this presentation.

[The prepared statement of William Ewing follows:]

Second Harvest®
NATIONAL FOOD BANK NETWORK
1001 North Central, Suite 303
Phoenix, AZ 85004 (602) 252-1777

September 22, 1983

TESTIMONY BEFORE THE SENATE FINANCE COMMITTEE REGARDING S. 1846 (SENATOR DANFORTH'S BILL)

I represent Second Harvest, the National Foodbank Network, comprising 62 major foodbank distribution centers throughout the United States. Our major mission is soliciting donations of edible but surplus food from the nation's food industry for distribution to local charities that serve the poor. In 1983 the Second Harvest Network expects to redistribute 100 million pounds of food donated by the private sector. Therefore, we have immense interest in the proposed legislation.

We enthusiastically endorse the Committee's efforts to broaden the eligibility of all retailers, wholesalers and growers and the tax deduction benefit available to these potential donors. This benefit is now limited only to non-Subchapter S corporations. We believe eliminating this inequity will significantly enhance our efforts to expand the participation of certain segments of the food industry and increase the volume of their donations. Currently, only a small percentage of farmers donate to foodbanks. A tax incentive will greatly increase the amount of nutritious produce available for distribution to the needy.

As we deal with the large volume of donated food that we now locate throughout the country each day, the cost of transportation becomes an issue of increasing importance. We are most appreciative of the transportation services that the larger rail and trucking companies have donated to us. We believe the opportunities provided by this bill will greatly improve our abilities to broaden our working relationship with all members of the transportation industry. Since transportation costs generally represent 15% of a foodbank's operating budget the donation of these services will allow the foodbanks to allocate resources into other pressing areas, such as improved warehouse facilities.

Foodbanks are membership organizations made up of private nonprofit feeding programs. We have long been concerned with the legislation that bars certain governmental organizations from membership. Generally, these would be units that provide services to those in crisis situations or rehabilitative care to the needy. For this reason, we are concerned with that portion of this bill that will permit large programs such as schools, hospitals, etc. with existing food budgets to receive donated food. We recommend that further study be given to the types of government programs that will be allowed to receive donated food so that:

1. resources are not drained away from private programs.
2. this legislation will not allow donated food to replace food provided as a principal function by such governmental agencies as prisons and schools.
3. current funding for social welfare programs not be jeopardized.
4. certain specific governmental programs be allowed to enhance and improve their care of the needy, especially in emergency situations.

Referring to page four, section four, we recommend the substitution of the appropriate section of the current law, with one modification, as follows:

"notwithstanding any other provision a contribution will not qualify under this section if the donee organization or any transferee of the donee organization requires or requests any money, property or services for the transfer or use of property contributed under Section 170(e)(3)."

We are strongly opposed to the concept of passing even minimal costs along to the ultimate receiver of this food. Our experience shows that some recipients wish to voluntarily contribute for donated food. This language we are proposing would not preclude this, but it would prohibit any organization from requesting or requiring a donation from a recipient.

We sincerely applaud the goals of this bill, which will increase the amount of donated food available for nonprofit feeding organizations, reduce certain foodbank costs and promote a strengthening of the relationship between the private sector and the charitable community. On behalf of Second Harvest food throughout the United States, I thank you for your efforts and for this opportunity to make this presentation.

STATEMENT OF ANN ALLEN, MEMBER, BOARD OF DIRECTORS, NATIONAL CITIZENS COMMITTEE ON FOOD AND SHELTER, WASHINGTON, D.C.

Ms. ALLEN. Good morning.

I am Ann Allen, director of communications for the American Logistics Association. It is a pleasure to be here this morning on behalf of the National Citizens Committee for Food and Shelter and to speak in support of S. 1826.

Before I begin I would just like to say that the last time the American Logistics Association worked with you, Senator, was the time of the prompt-pay legislation, and your foresight and leadership on that has brought about positive results. I think the Government is paying their bills a little more quickly, and I think that brings about a more productive relationship for an agreement. Our thanks to you on that.

I would like to describe briefly why there is a National Citizens Committee for Food and Shelter, what its mission is, and why your tax incentive legislation is an important link in providing food for the hungry people of our country.

The committee has representatives from both the public and the private sectors and was formed in the belief that public and private teamwork can help efficiently and economically to meet this country's basic food and shelter needs.

You know and I know that the problems of the hungry and the homeless slice through almost every segment of our population, in cities, towns, and in rural areas. And we know that to find successful solutions is critical.

This need is only accentuated by acknowledging the complicated and persistent nature of the problem. So the purpose of the committee is to forge a link between the power and the ingenuity of the Federal Government and the business community. This link we believe can provide forceful support for local programs which are meeting local needs.

The mission is to open doors, to encourage local programs, and to remove obstacles to getting the job done. The job to be done is to make food and shelter resources available to the hungry and the homeless wherever they are. Perhaps the best description is an example of the committee's work. I would like to outline how the committee worked with two of the largest government agencies to provide food. I am referring to the Department of Defense and the Department of Health and Human Services.

One of the key employee benefits provided for our military men and women are commissaries; the branches of service operate and manage these stores worldwide. Here in the United States there are 261 commissaries. The size of the stores vary, however many of them have a much higher volume per store than their civilian counterparts.

Whether civilian or not, every grocery store has a percentage of food and grocery items that cannot be sold. Sometimes packaging is damaged, or an item is mismarked, or an expiration date is passed. The food is still edible and nutritious, but it is called unmarketable. That food is a resource with the potential of feeding large numbers of people.

The Department of Health and Human Services realized that potential. The importance was due as much to the variety that it provides as to the quantity. It can provide an important nutritional supplement to the basic staple package most often distributed in feeding programs.

The National Citizens Committee formed a link of cooperation between the Department of Defense and HHS, and then worked jointly with the private suppliers to free up the food. The results are impressive. The American Logistics Association board of directors committed the association to help out and donate these nonmarketable foods to foodbanks. With this commitment, the Secretaries of Defense and HHS signed a memo of understanding, agreeing to support food banks.

Today there are 150 food banks certified and matched with commissaries around the country. Having put this system of voluntary local endeavor into motion, the committee is now available to assist if there are breakdowns in communication. If the program runs into snags, we can perhaps open up communication again.

Your legislation also is opening up many doors to getting available food to those who are hungry. It will also remove obstacles to the distribution of food. And we know that food distribution, not food production, is the great difficulty.

A combination of the tax deduction for incremental costs of transportation, the expansion of tax deduction to noncorporate donors, and the tax deduction given for gleaning provided a major incentive for farmers, processors, distributors, and retailers to cooperate and participate.

We believe the problems are very difficult, but we believe the benefits outweigh them.

I appreciate the opportunity of being here on behalf of the committee and offer any assistance that we can lend you in your effort.

Thank you.

[The prepared statement of Ann Lowell Allen follows:]

Testimony
before
the
Senate Committee on Finance
Subcommittee on Taxation & Debt Management
September 26, 1983

Submitted by:

The National Citizens Committee
on Food and Shelter

presented by:
Ann Lowell Allen
Member, Board of Directors

THE NATIONAL CITIZENS COMMITTEE FOR FOOD AND SHELTER, INC.

A Public-Private Partnership

The National Citizens Committee for Food and Shelter, Inc. is a nonpartisan, public-private partnership formed to be a resource support and information clearinghouse for existing agencies and services working to improve the condition of the hungry and of the homeless.

The goal of the Committee is to develop linkages between government and the private sector which coordinate programs that improve the provisions of food and shelter for the needy.

Incorporated in June, 1983, the Committee was formed in the belief that a public-private partnership can facilitate new structures and approaches to efficiently and economically meet this country's basic food and shelter needs. The Committee was initially organized by interested people in cooperation with the White House Office of Private Sector Initiatives. The Committee has expanded to include membership representing all sectors. At present the substantive work of the Committee is accomplished by two working task forces on hunger and shelter.

The Food Task Force in concert with the Congressional Omnibus Budget Reconciliation Act of 1982 seeks to encourage federal departments and private agencies to distribute to hungry people surplus food or food which would otherwise be discarded. The immediate focus of the Food Task Force is to distribute surplus food through the Department of Defense Commissaries and the foodbanking network. The Task Force is actively working to make government equipment and surplus warehousing available for foodbanks.

The Shelter Task Froce is the initiator and ongoing coordinator of programs utilizing existing federal buildings as shelter for the homeless. The immediate focus of the Shelter Task Force is to work with the Department of Defense and the Department of Housing and Urban Development to make available military facilities and foreclosed homes as potential temporary shelters for the homeless. The Task Force is also working with the National Park Service to develop a working shelter program in a national park.

The National Citizens Committee for Food and Shelter is actively developing a cooperative relationship with the National Governors' Association, the United States Conference of Mayors and various federal departments. The Committee will endeavor to build support of volunteer efforts utilizing existing agencies and service organizations for the purpose of coordination at the local level. The Committee will provide information on successful models of food and shelter programs for dissemination to the public and private sectors.

The National Citizens Committee for Food and Shelter acts as an educational resource on legislation pertinent to the issues of food and shelter, but does not endorse, advocate nor lobby for a specific public or private policy position.

The National Citizens Committee for Food and Shelter will not be involved in funding nor fundraising efforts other than to secure organizational operating expenses from private sources.

The National Citizens Committee for Food and Shelter welcomes the participation of all interested citizens to join with us to meet the critical needs of the country's hungry and homeless.

The "Hunger Relief Incentives Tax Act of 1983" makes a very important contribution to the issue of providing food for needy Americans.

Section 170(e)(3) of the Internal Revenue Code provides a special exception to the general rule that the deduction for charitable contributions of inventory-type property is limited to the donor's original cost. The exception applies solely to contributions of property to be used for the care of the ill, needy or infants. The amount of the deduction is the fair market value of the contributed property less one-half of the gain which would not have been long-term capital gain if the property had been sold.

This provision has been an important source of contributions for foodbanks. Foodbanks operate in communities throughout the country. In general, a foodbank receives surplus food from donors in the food industry who claim the deduction made available under Section 170(e)(3). The foodbank usually maintains a warehouse with freezer and cooler space for storage and provides for distribution to local organizations directly engaged in feeding the ill, the needy and infants. In order to distribute contributions to foodbanks in the most efficient manner, it has become necessary to establish a method to solicit, receive and distribute nutritious food from contributors to foodbanks throughout the country.

As the capacity of foodbanks and the volume of potential contributions has increased, obstacles have arisen which block the delivery of food to the needy. Perhaps the most serious obstacle is the physical transportation of donated food.

Contributions frequently arise in substantial quantities; i.e., a railroad carload of mislabeled juice or three-quarter filled cereal boxes. Since no single foodbank can assimilate such an enormous volume, it is necessary to locate a series of foodbanks which, in the aggregate, can receive and distribute the contribution. Unfortunately, the individual foodbanks cannot afford the transportation fees associated with the shipment of the contributed property. In addition, neither the donors nor the shipper can claim a deduction for shipment costs. As a result, these costs are becoming an increasingly large obstacle to the distribution of donated food.

S. 1826 suggests a way around that obstacle that we think deserves serious consideration. In general, the bill provides a deduction for transporting food. The National Citizens Committee is not prepared to say that the method of calculating the deduction contained in S. 1826 is the only--or even the best--system. We do feel, however, that removing the impediment of transportation costs has the potential to significantly increase the food available for needy Americans.

S. 1826 also addresses several other impediments to the delivery of food. First it allows donors to deduct the value of food contributed to governmental units. Second, it allows farmers and other noncorporate taxpayers to deduct the value of donated food. Each of these changes should expand the universe of donors as well as improve the actual delivery of food.

The "Hunger Relief Incentives Tax Act of 1983" focuses upon three crucial areas in the feeding of needy Americans--encouraging more contributions, better delivery and a wider network of service providers. We commend Senator Danforth for bringing these issues to the attention of the Congress and wish to offer our assistance in exploring any and all options to assist those Americans who suffer from hunger.

Senator DANFORTH. Thank you very much.

Mr. Ewing, thank you for your suggestions. We will work with you on that and see if we can update it or work something out.

On the more general question of the bill and the direction the bill is moving in, how significant is this bill?

Mr. EWING. For us it is very significant. Transportation is an area that we do need help in. There is food that is offered that we cannot get transportation support on. Although I don't think that we have ever let anything go, we have had to struggle. I think that some tax incentive for transportation companies would be very helpful to us.

Farmers don't get any tax advantages, and they've got food that we want as much as any food there is. It is nutritious, it is available in some quantity, and we would like to see any encouragement for farmers to participate in a donation program. Some do right now, but it's on a relatively small level.

The government agencies? There are department of social service agencies that have emergency feeding programs that finance their operations virtually out of the pockets of the social workers in the office. We would like to see ways in which we can work with these organizations, with the government soup kitchens—some of the State government soup kitchens or city government soup kitchens. We would like to help these people very much.

We see this bill as being extremely important, primarily in these three areas.

Senator DANFORTH. Ms. Allen.

Ms. ALLEN. Yes. I just want to support this, on distribution. The matter of food distribution is often very much a matter of a local nature. Food distribution companies tend to be local in nature and not national. If we could give them an encouragement so that they are not having to pay out money to assist in moving food from one area to another area, to make some of the excess food available, then I believe it would not only be an economic incentive to them but would give them a clear signal of the kind of support that is being put behind these programs.

Senator DANFORTH. As I said to Mr. Pearlman, what struck me when I visited a whole variety of providers in my State was the number of times that they mentioned the problem of transportation—unsolicited by me, but just all kinds of providers mentioning the difficulty of transportation. They could get the food, it would be available, but to move it was a different matter. They needed funds. They wanted some funds to do that. Well, the purpose of this is to not make grants but to encourage the availability of private transportation.

Ms. ALLEN. If we could tap in to that expertise of local wholesale groceries and distribution people, if we could actually get into that—take again the expanding, for instance, some of the distributors who bring food to Fort Leonard Wood, for example, and get them out beyond and thinking of other ways, I think that that kind of expertise would really go a long way to getting the job done.

Senator DANFORTH. Right.

Mr. EWING. May I say one thing on the transportation issue? We often get food donated to us in extremely large quantities on the spur of the moment, and we have to move it right away. It may very well be perishable. This costs us a lot of money, because we have to go out and take the first available transportation. If a system was in place, some ability to move that donated food, working with the transportation industry, we would be in much better shape to accept this good food quickly.

Senator **Danforth**. With respect to the tax incentives for the contribution of food, particularly by farmers, it would appear to me to be a very peculiar governmental policy if we are paying farmers for food which is stored, but not encouraging them to provide food which will be eaten. It would seem to me that we are then weighing in in favor of the storage of food. We are storing immense quantities.

Missouri has become the center of cheese storage in the country, and this simply says, "Look, we are going to treat noncorporate farmers the same as corporate farmers. Why do you have to be a big corporate farmer in order to avail yourself of this? We are going to encourage that food which is out there to be eaten."

So I think that it makes sense as far as logic is concerned; as far as feeding people who are hungry it makes a lot of sense.

Thank you both very much for being here.

Mr. **Ewing**. Thank you, sir.

Ms. **Allen**. Thank you.

Senator **Danforth**. That concludes the hearing.

[Whereupon, at 11:59 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

ALUMINUM COMPANY OF AMERICA
ALCOA BUILDING · PITTSBURGH, PENNSYLVANIA 15219
A. E. GERMAIN, Tax Counsel
ALCOA

1983 September 23

The Honorable Robert Packwood
Chairman
Subcommittee on Taxation and Debt Management
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

We appreciate the opportunity to comment on S. 1584 which will eliminate certain unintended inequities in the Internal Revenue Code by providing for an overall domestic loss recapture rule under §904(f) and by conforming the foreign tax credit carryover and ordering rules with the investment tax credit and net operating loss rules.

The Tax Reform Act of 1976 added §904(f) to recapture a prior year's foreign source loss against latter year's foreign source income by recharacterizing the latter into domestic source income, solely for purposes of the foreign tax credit limitation calculation. Section 904(f) was enacted to prevent a taxpayer from deriving a double tax benefit from a foreign source loss, i.e., double counting. The 1976 Act was incomplete, however, in that it did not provide a parallel rule for the recapture of domestic losses in order to prevent a double tax burden.

Where a company, such as Alcoa, would suffer an overall domestic loss, that domestic loss would partially or completely offset foreign source income which would reduce or eliminate the foreign tax credit in that year. In such a case, a company is unable ever to include that foreign source income in its determination of the foreign tax credit limitation. Since the foreign income tax rates paid by many companies equal or exceed the U.S. rate, it is unlikely that the excess foreign tax credit generated, in such situations, will ever be utilized within the carryover period.

It is therefore necessary, in such cases, to recharacterize a domestic source loss in order to eliminate an unintended and inequitable double tax burden. This double burden occurs when foreign income is offset by a domestic loss which prevents creditability of foreign taxes actually paid on such foreign

The Honorable Robert Packwood
1983 September 23
Page Two

income. Failure to recapture domestic source losses produces a significant degree of double taxation of foreign source income which occurs solely as a result of the lack of uniformity in the treatment of overall foreign losses and overall domestic losses under §904.

We have attached an example which illustrates the operation of the domestic loss recapture rule under S. 1584 and demonstrates the double tax results without such recapture.

In addition, S. 1584 will conform the foreign tax credit carryover and ordering rules with the investment tax credit and net operating loss rules. The carryover period will be 15 years and a FIFO rule will be applied so that the oldest credits are used first. We know of no reason why the foreign tax credit rules should be singled out to remain under the 1958-vintage 5-year carryover subject to a rule requiring the current year's credits to be used before credits carried over from a prior taxable year.

Originally, both the investment tax credit and the foreign tax credit had a 5-year carryover and the archaic LIFO-type ordering rule. The investment tax credit has been modernized and so should the foreign tax credit. The present 15-year carryover period for the investment tax credit and the FIFO ordering rule are the result of a series of amendments, primarily in 1976 and 1981, which reflected the growing recognition that the older, unduly restrictive carryover and ordering rules produced random and arbitrary distortions for taxpayers that are not justified by tax policy. Therefore, a 15-year carryover and a FIFO ordering rule for the foreign tax credit would be appropriate and consistent.

Again, we thank the Subcommittee for this opportunity to comment and urge the passage of this legislation. We respectfully request that this letter be made part of the record of this hearing.

Sincerely,

AEGermain

Albert E. Germain
Vice President - Taxes

RNK/dad

Attachment

WRITTEN STATEMENT OF H. STEWART DUNN, JR., OF IVINS, PHILLIPS & BARKER

ON BEHALF OF

AMF INCORPORATED, BLUE BELL, INC., EATON CORPORATION, AND THE ROCHESTER TAX COUNCIL

FOR INCLUSION IN THE RECORD OF A HEARING BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, COMMITTEE ON FINANCE, UNITED STATES SENATE, OF SEPTEMBER 26, 1983 REGARDING S.1584 - THE FOREIGN TAX CREDIT CONFORMITY ACT OF 1983

AMF Incorporated, Blue Bell, Inc., Eaton Corporation, and the Rochester Tax Council strongly support the enactment of S.1584 "The Foreign Tax Credit Conformity Act of 1983," introduced by Senators Danforth, Bentsen and Huddleston.

AMF Incorporated is a diversified multi-national corporation headquartered in White Plains, New York. In 1982 the company earned $1,054 million in revenues. AMF operates in five major areas: (1) petroleum exploration, drilling and transportation services, (2) the manufacture and sale of sporting and recreational equipment, (3) the manufacture and sale of electrical and electronic controls, (4) the manufacture and sale of purification filters for consumers and industry, (5) the manufacture and sale of automation equipment from tobacco processing machinery to fast-food equipment. AMF employed approximately 17,300 persons at the end of 1982, down from 20,200 a year earlier. In 1982 AMF earned foreign gross revenues of approximately $350 million. Its foreign operations generally have been profitable (in 1982 its foreign net income was over $17 million) and have borne an average foreign income tax rate in the neighborhood of 40%. Domestically, however, at least during the recent recession, AMF has fared less well. It reported a tax loss of approximately $26 million for 1982 due, in part, to recession-associated operating difficulties. AMF has been forced to forego approximately $10 million in potential domestic tax benefits, in 1982 and will forego approximately $17 million in 1983, benefits chiefly intended to encourage increased and continued capital improvements and research and development. To some extent, foreign profits have been used to sustain domestic operations. AMF faces competition from foreign manufacturers in many of its product lines both in its U.S. and in its foreign markets. At the end of 1983, AMF will have approximately $17.4 million in excess foreign tax credits that it will be unable to use, despite the fact that its foreign source income bears an average foreign tax rate less than the U.S. rate. Under present law, in order to utilize these foreign tax credits, AMF would have to realize $24 million of foreign source income (that was completely untaxed by the foreign country, including withholding taxes) by the end of 1987 and an additional $13 million of such untaxed foreign source income by the end of 1988, or $183 million of foreign source income taxed at its average foreign rate of 40% by 1987 and $100 million of such income by 1988. Due entirely to the generation of additional, unusable foreign tax credits, AMF will not repatriate foreign subsidiary dividends at the same rate it would if those dividends gen- erated usable foreign tax credits. In 1981 and 1982, for example, AMF repatriated $8.1 million and $8.2 million, respectively, in foreign source dividends from controlled foreign corporations (not including deemed dividends under Subpart F). In 1983 that number will fall to $850,000 despite an increased need for capital in its U.S. operations this year. Much of the 1982 dividend and virtually all of 1983's were preciptated by foreign currency devaluations.

Blue Bell Inc., headquartered in Greensboro, North Carolina, is one of the world's largest apparel manufacturers with facilities in twenty-three states, Puerto Rico, and fourteen foreign countries. Blue Bell has approximately 29,000 employees. Among its products are Wrangler jeans and Jantzen sportswear. Blue Bell faces significant competition from foreign apparel manufacturers in both its U.S. and foreign markets. Domestically, in 1982, on sales of $1 billion, Blue Bell earned $113 million in operating profit before corporate and interest expenses and income taxes. From international operations, the company had sales of nearly $300 million in

1982 on which it suffered a net reported tax loss of $53 million. Blue Bell anticipates that it will report another sizeable tax loss for 1983. While Blue Bell has only $3 to 4 million of excess foreign tax credits, because of its recent foreign losses and the operation of the foreign loss "recapture" rule, the company must repatriate approximately $50 million of untaxed foreign source income to absorb those credits. Because Blue Bell's foreign operations bear an average foreign tax rate of nearly 46% and because the $50 million repatriation would bear substantial U.S. taxes, it will be substantially impossible to prevent the expiration of these credits.

Eaton Corporation, headquartered in Cleveland, Ohio, is a manufacturer of advanced technology products for industry. The company employs approximately 40,000 at 170 facilities on six continents. Eaton's principal products include electronic and electrical automation systems and equipment, aerospace and defense systems, capital goods components used for industrial process and power control, consumer goods components including circuit breakers and components for appliances and power tools, valves and other engine components for passenger cars and trucks, transmissions, axles and brakes for medium and heavy duty trucks, and mechanical and hydrostatic transmissions and hydraulic motors for off-highway vehicles. Eaton has been particularly severely affected by the recession and the impact of foreign competition on the North American automobile market. In September 1982 few of the company's divisions were operating at more then 50% of capacity and some were closer to 25%. For 1982, Eaton posted a loss from continuing operations (after provision for plant closings and income taxes) of $71 million and a total net loss (including loss from discontinued operations) of $189 million, Eaton's first yearly loss since the depths of the Great Depression. Despite significant efforts to cut costs in 1982, however, Eaton's did not neglect product development; it increased spending from $90 million in 1981 to $100 million in 1982. In 1982 Eaton reported a U.S tax loss of approximately $63 million. Eaton's foreign operations helped to keep that figure from growing even larger, earning approximately $29 million of foreign source income in that year. Chiefly because of the domestic tax loss (Eaton's average foreign tax rate is only 40%), Eaton has over $12 million of excess foreign tax credits that may never be utilized. The company would need to repatriate about $30 million of entirely untaxed foreign source income to utilize these credits, an impossibility given Eaton's average foreign tax rate of 40%. In large part because of its excess foreign tax credit situation, Eaton has been reluctant to bring home foreign subsidiary dividends that would generate more usable foreign tax credits. In 1983 Eaton has cut its foreign subsidiary dividends to the bone, bringing home only $1.7 million from controlled foreign corporations (other than Subpart F income) as compared to $8.4 million in 1982. As a result, at the very time Eaton's domestic operations are most in need of an infusion of capital from the company's more profitable foreign operations, the U.S. tax law has discouraged that remedy.

The Rochester Tax Council is an organization of major companies in the Rochester, New York area. Its members include Bausch and Lomb, Champion Products, Gannett, Garlock, Gleason Works, Eastman Kodak, R.T. French, Schlegel, Security Trust, Sybron, and Xerox. The members have varied product lines from consumer photographic equipment to a variety of business machines to precision optical equipment. Several of its members have significant excess foreign tax credits that are likely to expire unutilized due to foreign or domestic losses, despite foreign tax rates of less than 46%.

Each of these taxpayers will have substantial excess foreign tax credits which probably will expire, unused, in the next few years. Unfortunately, the next few years are the very times when such taxpayers will urgently need these earned but unused tax benefits to assist in the restoration of their domestic operations from the ill effects of the 1981-1982 recession. Almost without exception, these excess credits do not arise because these taxpayers are operating in countries whose income tax rates exceed the U.S. 46% corporate rate. Instead, they reflect the impact of substantial recession-induced domestic and foreign source losses on the foreign tax credit carryover computations. The present foreign source loss recapture rules, coupled with the relatively short five-year carryforward period for unused foreign tax credits, expose these taxpayers to harsh double taxation (measured on a multi-year basis) of a very serious magnitude, which unfortunately will come to pass in the near future in the absence of corrective legislation. The enactment of S.1584 would help to address each of these problems for the taxpayers described above by (1) providing a domestic loss recapture rule and (2) conforming the foreign tax credit carryforward/carryback and ordering rules to those used for other tax credits and net operating loss deductions.

Double Taxation

We readily admit that the mere existence of expiring excess foreign tax credits does not necessarily indicate the existence of double taxation. Excess foreign tax credits arise because of the application of the foreign tax credit limitation of section 904. The foreign tax credit limitation works to accomplish two goals. First, it attempts to assure that a foreign tax credit is available only on foreign source income, not on domestic income. Second, it attempts to insure that foreign taxes on foreign source income are creditable only to the extent they do not exceed U.S. tax rates (generally 46% for corporations). Where this second rationale operates alone and excess foreign tax credit are generated by consistently higher foreign tax rates on foreign source income, we admit that the specter of expiring foreign tax credits does not present a tax policy problem.

Excess foreign tax credits can be generated by the operation of the first rationale, however, and in such cases does present a tax policy problem. Timing differences in reporting of income and deductions between U.S. and foreign tax laws, for instance, may result in excess foreign tax credits. Similarly, differences between the rules for sourcing income and for allocating deductions can result in permanently growing excess foreign tax credits. Finally, and perhaps most important after the recent recession, substantial excess foreign tax credits can be created by domestic tax losses. Domestic tax losses, of course, can be generated not only by operating losses, but can also be generated, in part, at least, by significant capital expenditure programs resulting in large ACRS and R&D deductions.

Were taxable income computed and analyzed on an annual basis only, but for differences between foreign and domestic sourcing of income rules or deduction allocation rules, the foreign tax credit limitation would generally work to assure that double taxation was eliminated. Taxable income under our system, however, is not always viewed only on an annual basis. A variety of provisions including income averaging, net operating loss carryforwards, and the investment credit carryforward, recognize that, on occasions, it is appropriate to look beyond a single annual accounting period in order to accurately compute taxable income and tax. Even the foreign tax credit has such a provision, § 904(f), to assure that annual variances in taxable income, namely temporary foreign losses, do not work to the government's detriment. But for the short carryback (two years) and modest carryforward (five years), however, the foreign tax credit has no such rule moderating the harshness of using the annual accounting period when the computation of taxable income, tax and tax credits on a strictly year by year basis works to the taxpayer's detriment.

In enacting § 904(f)'s foreign loss recapture rule and the foreign tax credit carryback and carryforward, Congress and the Treasury have clearly indicated that relief from double taxation cannot be measured simply on an annual basis. Only if one looks beyond the annual accounting method does the perceived abuse at which the existing foreign loss recapture rule of section 904(f) is aimed become apparent. On a strictly annual basis, double taxation is eliminated and no double benefit is granted, even without the foreign loss recapture rule. An example will help illustrate this:

	Year 1	Year 2	2-Year Total
Foreign source income (loss)	($100)	$100	0
U.S. source income	100	100	$200
U.S. taxable income	0	200	200
Foreign tax (46 percent)	0	46	46
U.S. tax before credit (46 percent)	0	92	92
Allowable foreign tax credit	0	46*	46
Net U.S. tax	0	46	46
Excess foreign tax credit	0	0	0

---

* Foreign tax credit limitation: Foreign source income ($100)/total taxable income ($200) X pre-credit U.S. tax ($92) = $46.

In Year 1, the taxpayer has no U.S. taxable income and pays no U.S. tax. This is the correct result for that year viewed alone. In Year 2, the taxpayer has $200 of U.S. taxable income on which he has paid $46 of foreign tax. Giving proper allowance for the foreign tax credit, he pays an additional $46 of U.S. tax for a net U.S. tax of $46 but a total U.S. and foreign tax of $92. Taking Year 2 alone, this, too, is the correct result. When the two years are added together, however, it is apparent that $200 total U.S. source income has borne only $46 total U.S. tax, one-half the amount that one would expect. Only by looking beyond the annual accounting period can any "problem" be perceived. This problem is resolved, under § 904(f), by treating the foreign source income in Year 2 as domestic source, thus eliminating the foreign tax credit available in Year 2 and making the total two year tax bill $92. This "creates" double taxation in Year 2 when viewed in isolation, but eliminates the double tax benefit when one looks at the two years at once. In essence, § 904(f) mandates a net operating loss carryforward for the foreign source income whether or not the foreign tax laws so permit. When the government may suffer from the strict application of the annual period computation, therefore, Congress and the Treasury have no qualms in abandoning the annual accounting period as an incorrect computational period.

When this same phenomenon works in reverse, however, when the taxpayer suffers from the strict application of the annual accounting period (i.e., where he suffers a U.S.-source loss) the present law permits no relief and ignores the multi-year impact. Again, an example will help illustrate the problem:

	Year 1	Year 2	2-Year Total
Foreign source income	$100	$100	200
U.S. source income (loss)	(100)	100	0
U.S. taxable income	0	200	200
Foreign tax (46 percent)	46	46	92
U.S. tax before credit (46 percent)	0	92	92
Allowable foreign tax credit	0	46*	46
Net U.S. tax	0	46	46
Excess foreign tax credit	46	0	46

---

* Foreign tax credit limitation: Foreign source income ($100)/total taxable income ($200) X U.S. tax ($92) = $46.

Thus, over two years, the taxpayer has paid a total of $138 in taxes - $46 U.S. and $92 foreign - on net income of $200 (consisting solely of foreign source income) - a rate of 69%. Unless the taxpayer has substantial future foreign source income bearing little or no foreign tax, the excess foreign tax credit is likely to expire unused in five years. Admittedly, a year by year analysis will reveal no double taxation. Looking at the two year picture, however, (as present law under § 904(f) insists whenever it is to the government's benefit) there is significant double taxation.

Two obvious methods recommend themselves to eliminate this unfair and inconsistent treatment. The present law foreign loss recapture rule under § 904(f) could be repealed. This would preserve the sanctity of the annual accounting method in applying the foreign tax credit limitation. Alternatively, as S.1584 proposes, it could be recognized that the perils of double taxation (and double tax benefits) cannot be dealt with on a strictly annual basis, but must be addressed on a multi-year basis. Therefore, S.1584 proposes a domestic loss recapture rule that mirrors the present foreign loss recapture rule. The bill also proposes an extended foreign tax credit carryforward. This logical and entirely consistent approach would do much to alleviate the double tax suffered by AMF, Blue Bell, Eaton, and the members of the Rochester Tax Council when their incomes are viewed on a multi-year basis. Certainly if Treasury is to continue to argue that the multi-year picture of foreign tax credit benefits required by the foreign loss recapture rule is to be retained, they cannot be heard to argue in all seriousness (see statement of Ronald A. Pearlman, Deputy Assistant Secretary (Tax Policy) before the Subcommittee on Taxation of Debt Management, September 26, 1983, at page 12), that domestic losses can create no double tax burden since double taxation is appropriately viewed on a single year by single year basis.

Impediments to Repatriation of Foreign Source Income

When domestic operations are in need of cash for capital improvements, operational subsidies, or other reasons, a multi-national corporation may wish to repatriate dividends from its foreign subsidiaries. Tax and other regulatory rules that prevent the business-motivated redeployment of capital, particularly the use of dividends from a company's own foreign subsidiaries to be used to bolster its faltering domestic operations, can only increase economic inefficiencies, contribute greater instability to domestic operations and force more domestic borrowing which will, in turn, put increasing pressures on U.S. credit markets already burdened by the enormous federal deficit. The present lack of a domestic loss recapture rule and the short foreign tax credit carryback/carryforward rule are just such impediments.

If the domestic parent is unable to utilize the foreign tax credits associated with dividends that might be repatriated from its foreign subsidiaries, either because of domestic losses or because of the doubtful outlook for ultimate utilization of the credits within the carryforward period, the real after-tax value of those dividends will be reduced substantially. This might well lead the domestic parent to refuse to repatriate earnings from its foreign subsidiaries and reinvest those earnings in foreign operations or place them in foreign bank accounts for the benefit of foreign credit markets. This could force the cancellation of domestic investment (or even the closing of domestic plants that can survive only on cheaper, internally generated funds). Even if the domestic investment goes forward or the plant remains open, the failure to use foreign earnings for these purposes may increase the company's short term domestic borrowing in an expensive domestic credit market already overburdened by the specter of enormous federal borrowing to fund enormous federal deficits. The retention of foreign earnings abroad in such a situation will only continue to keep foreign interest rates relatively low, keep U.S. interest rates abnormally high, and, therefore, exacerbate the present abnormal strength of the dollar to the detriment of our export and balance of payments problems. By discouraging repatriation, the foreign tax credit rules encourage expansion overseas rather than in the United States.

Competitive Disadvantage

The generation of usable foreign tax credits reduces the real after-tax (on a world wide basis) cost of doing business abroad for U.S. taxpayers. Whenever, therefore, foreign operations produce foreign tax credits that cannot be utilized, those operations will bear a higher cost of doing business abroad than their U.S. competitors who are not in an excess foreign tax credit situation and often higher than their foreign competition as well. While this will be true whenever excess foreign tax credits are generated and not utilized, it is particularly harmful where, as discussed above, those excess unused foreign tax credits represent the exposure of American foreign operations to double taxation. Because domestic losses will exacerbate the problem of excess unused foreign tax credits, those companies most in need of insuring that their foreign operations remain as profitable as possible will be affected the most.

Reduced Domestic Investment Incentives

Taxpayers who have domestic losses while they are paying foreign tax on foreign income in the same taxable year may loose the full benefit of the accelerated cost recovery system deductions and other domestic investment incentives. Domestic tax losses, including ACRS deductions, will initially offset same-year foreign income before being eligible to be carried back or carried forward. Computationally, this occurs before any application for foreign tax credit. A taxpayer with relatively high-taxed foreign income, however, would pay no U.S.

tax on that income because of the foreign tax credit, regardless of the impact of his domestic ACRS and other deductions. Because the ACRS and other deductions must first be applied against foreign income (which would not be taxed in any event because of the later application of the foreign tax credit), however, the carryback and carryforward of the ACRS deductions and other investment incentives will be reduced. The high-taxed foreign income has, in effect, consumed two tax benefits. The elimination of a portion of the carryforward for ACRS and other investment deductions will, of course, reduce the incentive intended to be provided by such provisions. The domestic loss recapture proposed in S.1584 and a foreign tax credit carryforward equal in length to the net operating loss carryforward period would, in effect, return the benefits of ACRS to the taxpayers in later years and preserve the intended incentive.

Parallel Net Operating Loss Carryforward

The net operating loss carryforward functions as a general averaging device to alleviate the harsh effects often resulting from the use of the one-year accounting period required generally for computing taxable income. The net operating loss carryover also shields businesses during difficult economic times and reduces differences in the total tax liabilities, over a multi-year period, of taxpayers with equal income over the period, some of whom have net operating losses and some of whom do not during the period. Since the enactment of the Economic Recovery Tax Act of 1981, net operating losses may be carried forward for fifteen years.

The foreign tax credit carryforward performs very much the same function, alleviating the harsh effects often resulting from the use of the one-year accounting period. Excess credits generated by timing differences, by differences between sourcing rules or deduction allocation rules and by temporary domestic losses may be utilized in carryforward years. This is intended to shield businesses during difficult economic times and reduce the differences in the total tax liabilities (measured over a multi-year period) of taxpayers with equal foreign incomes over the period, some of whom are affected by domestic losses or timing differences and some of whom are not. Since the foreign tax credit carryforward plays a very similar role to the net operating loss carryforward it seems entirely logical to provide a fifteen year foreign tax credit carryforward, as S.1584 proposes.

The enactment of S.1584 would significantly ameliorate, though not in all cases eliminate, the expiration of excess foreign tax credits generated by infirmities caused by computing domestic and foreign taxable income on a strictly annual basis. For the reasons stated above, AMF Incorporated, Blue Bell, Inc., Eaton Corporation and the Rochester Tax Council wholeheartedly support the enactment of S.1584.

BUCKNELL

Office of the President

Bucknell University
Lewisburg, Pennsylvania 17837
Phone (717) 524 1511

October 4, 1983

The Honorable Bob Packwood
Senator of the United States
Russell Senate Office Building
Room SR-259
Washington, D.C. 20510

Attention: Mr. John Colvin, Legislative Director

Dear Senator Packwood:

It is my understanding that hearings are under way in the Subcommittee on Taxation and Debt Management with regard to Senate Bill S-1815 to amend the Internal Revenue Code of 1954 to exempt from taxation corporations which acquire and manage real property for certain other exempt organizations.

On behalf of Bucknell University, I should like to go on record endorsing the proposed Senate Bill S-1815. Institutions like Bucknell need to have greater options in managing their endowment accounts. Passage of this legislation would provide additional opportunities for professional management of appropriate endowment investments.

It is my understanding that the proposed Bill S-1815 would permit institutions like Bucknell to indirectly become equity owners of leveraged real estate without incurring the unrelated business income tax. Moreover, the proposed legislation would permit educational institutions to streamline the administration of real estate investments. Many 501(c)(3) institutions have endowments which are too small to permit prudent, diversified real estate investments under present law. The proposed legislation would remedy this problem.

We will deeply appreciate your interest and support for this legislation.

Yours sincerely,

Dennis O'Brien

Dennis O'Brien

COUNCIL ON FOUNDATIONS
1828 L STREET NW WASHINGTON DC 20036 (202)466-6512

September 23, 1983

The Honorable Bob Packwood
SR-257 Russell Senate Office Building
Washington, D.C. 20510

Re: Support of S. 1815

Dear Senator Packwood:

Over the past few weeks, several major foundations who are members of the Council on Foundations have expressed serious interest in your bill, S. 1815, introduced on August 4, 1983. I am writing to let you know that the Council wishes to go on record in support of this bill.

As you know, all 22,000 private grantmaking foundations are tax exempt under Section 501(c)(3) and hold combined assets exceeding $51 billion. While many foundations do not presently own land or real estate as part of their assets, several have expressed strong interest in exploring better ways to diversify their holdings. Your bill would greatly facilitate the opportunity for the formation of organizations to acquire and manage real estate for certain exempt organizations, including private foundations. Initial feedback from our members indicates that the successful passage of your bill would be very favorably received.

We greatly appreciate your interest and leadership on this issue, and we look forward to working with you very soon on other foundation-related legislation (especially S.1857) as it moves ahead.

Sincerely,

James A. Joseph

James A. Joseph
President

JAJ:ab

STATEMENT

OF

THE GROCERY MANUFACTURERS OF AMERICA, INC.

ON

S. 1826

BEFORE THE SUBCOMMITTEE

ON

TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

WASHINGTON, D.C.

OCTOBER 10, 1983

Grocery Manufacturers of America, Inc., 1010 Wisconsin Avenue, N.W., Washington, D.C. 20007•(202) 337-9400•TWX: 710-8229364

Mr. Chairman and members of the Committee, the Grocery Manufacturers of America is the trade association representing the leading manufacturers of products sold in grocery stores throughout the United States. Our members employ 2.5 million people and have sales of more than $200 billion annually.

GMA is pleased to have this opportunity to express support for a tax incentive for the transportation of product donated to charitable organizations.

Our members support food banks at both the national and local level by donating the products they manufacture. Through the efforts of Second Harvest, the national food bank network, more than 70 million pounds of food were channeled to the needy last year, and the figure is expected to double in 1983.

Our members, creators of the safest, most efficient grocery distribution system in the world, understand that movement of the large quantities of product flowing through the food bank network requires the operation of an efficient distribution system to ensure the safety of fresh and perishable food and to keep costs low.

While food banks have been doing an admirable job of meeting these demands with limited resources to date, pressures on the system are mounting as food banks attempt to accommodate the increasing size and frequency of shipments.

Expenses for transportation services currently average about 15 percent of a food bank's budget. In some western states where distances between food banks and donors are greater, it represents 20-25 percent and is increasing, even though donors and common carriers provide transportation services at no cost from time to time. A tax incentive may serve to encourage regular and routine participation, reducing food bank expenses and increasing the efficiency of the system.

Without donated transportation, a food bank, using its own equipment, must often arrange for piecemeal pickup of a large donation over a period of several days or weeks. Not only does this delay distribution of the product to the needy, but it also reduces the efficiency of the donor's warehouse operation and may result in additional storage costs if the shipment is located in a commercial warehouse.

It is also extremely costly for food banks to move a surplus of fresh produce gleaned from western agricultural areas to eastern cities. A transportation tax incentive may facilitate distribution over a wider geographic area, providing each food bank with a more varied inventory and expediting consumption of perishable products, while reducing waste.

By encouraging the donation of transportation services by both common carriers and product donors a tax incentive will serve to ease food bank budgets, promote the efficiency of the system and expedite distribution to the ultimate beneficiaries: the ill, the needy and infants.

Thank you for this opportunity to express our views.

#

LAW OFFICES
GROOM AND NORDBERG
CHARTERED
SUITE 700
1775 PENNSYLVANIA AVENUE, N. W.
WASHINGTON, D. C. 20006
(202) 857-0620
DEX (202) 659-4503

THEODORE R. GROOM
CARL A. NORDBERG, JR.
ROBERT B. HARDING
LAWRENCE J. HASS
LOUIS T. MAZAWEY
MICHAEL F. KELLEHER
IRENE PRICE
STEPHEN M. SAXON
GARY M. FORD
DANIEL HOROWITZ*
ROBERT P. GALLAGHER
DOUGLAS W. ELL
WESLEY D. WORNOM

*ADMITTED IN VA. ONLY

HOWARD J. SILVERSTONE
OF COUNSEL

October 7, 1983

The Honorable Bob Packwood
Chairman
Subcommittee on Taxation
and Debt Management
Committee on Finance
United States Senate
Washington, D.C. 20510

Re: September 26, 1983
Hearing on Six Miscellaneous
Tax Bills -- Statement in
Support of S. 1815

Dear Mr. Chairman:

This statement is respectfully submitted, on behalf of Goldman, Sachs & Company ("Goldman Sachs"), for consideration by the Subcommittee on Taxation and Debt Management in connection with the September 29, 1983 hearing, and for inclusion in the printed record of that hearing. Goldman Sachs is a New York limited partnership that is one of the largest international banking and brokerage firms in the United States. This statement relates solely to S. 1815, a bill to exempt from taxation corporations which acquire and manage real property for certain other exempt organizations. We strongly support S. 1815, and urge that the bill be expanded to allow collective investments through group trusts as well as corporations.

Problems with Present Law

The current tax laws unnecessarily restrict the manner in which the funds of private foundations, university endowments, state and local governments, and other tax-exempt organizations may be invested. These organizations are not able to pool their assets in a corporation or group trust managed by a professional asset manager, such as Goldman

Sachs, without jeopardizing the exemption of those assets from tax under section 501(a) of the Code. Because asset managers must protect the tax exemption of the group trust or corporation, the effect of this exclusion of tax-exempt organizations is not to increase tax revenues. Instead, the effect is to preclude professional asset managers from offering collective investment vehicles that private foundations, university endowments, state and local governments, etc., may participate in, and to force such tax-exempt organizations that wish to enjoy the benefits of pooled funds to seek alternative forms of investment. We believe these effects are contrary to sound tax policy and good investment strategy.

At present, tax-exempt organizations may, of course, retain professional assistance in managing their funds. Under current law, however, unless a limited partnership is entered into with the attendant costs and complications, banks are the only asset managers who are able to invest the pooled funds of private foundations, university endowments, state and local governments, etc., on a tax-exempt basis. This disparity in tax treatment places other professional asset managers such as Goldman Sachs at a competitive disadvantage, and restricts the investment choices available to these organizations, for no apparent purpose.

Advantages of Collective Investments

S. 1815 would provide equitable treatment for non-bank professional asset managers, by allowing them to invest the funds of a broader class of tax-exempt organizations on a collective basis. This would result in expanded competition for the investment funds of tax-exempt organizations, to the advantage of those organizations.

Collective investment vehicles managed by professional asset managers have the capacity to provide a variety of benefits for tax-exempt institutions such as private foundations, university endowments, and state and local governments. The most obvious benefit is to provide sophisticated asset management at a reasonable cost. An exempt organization placing funds with an investment manager may obtain greater diversification of investment, the advantages of independent, professional management, and economies of scale. In addition, by combining funds with other tax-exempt entities, these organizations would be able to participate in investments that may not otherwise be available to the individual organization. As a result, higher yields may be realized, and greater diversification of risk obtained, than if the investments were undertaken directly.

An additional advantage of collective investments is that they are ideally suited to investment in real estate. The high cost of real estate, particularly if the investment is to be diversified, places it beyond the means of all but the largest tax-exempt organizations if ownership is held by a single organization. Tax-exempt organizations commonly seek stable, long-term sources of revenue; pooled real estate investment is therefore frequently desired.

S. 1815 Should Be Expanded to Include Group Trusts

We recommend that S. 1815 be expanded to allow collective investments through group trusts as well as corporations. (This could easily be done by replacing the word "corporation" in proposed section 501(c)(24) with the phrase "corporation or trust.")

The advantages of group trusts managed by non-bank professional asset managers have been repeatedly recognized in other areas of the tax laws. For example, pension plans have a particularly visible need for the sophistication, security, and economies of scale available in group trusts. The tax exemption afforded to pension funds under section 501(a) is "passed through" in this situation; preservation of the underlying tax-exempt status of the funds allows plans to more fully use the services of professional asset managers without unnecessary restrictions. See Rev. Rul. 81-100, 1981-1 C.B. 326. As recently as the 1982 tax act, Congress reaffirmed the benefits of group trusts managed by non-bank professionals by providing that governmental pension plans may participate without threatening the trust's tax-exempt status, even if the governmental plan has not been determined to be tax-qualified. I.R.C. § 401(a)(24).

Because group trusts are already in existence for the benefit of pension plans, it would be relatively simple for many trusts to allow other tax-exempt organizations to participate, instead of incurring the legal and administrative costs associated with the establishment of a collective investment corporation. Another reason to expand S. 1815 to include group trusts is that the powers and authorities of the trustees of group trusts are generally well established under federal laws, such as the Employee Retirement Income Security Act of 1974 ("ERISA"), and state trust laws. Finally, state laws also provide varying degrees of limited liability for organizations that invest in group trusts as well as for shareholders of collective investment corporations.

We also note that group trusts are currently regulated with extensive safeguards for the protection of investors. This regulation is pursuant to ERISA, various provisions of the Federal securities laws, and state laws.

Conclusion

In summary, for all of the above reasons, we strongly support S. 1815 and urge that it be expanded to allow collective investments through group trusts as well as corporations. We would emphasize that this would not result in a loss of tax revenues. We would also emphasize that such a provision is necessary to allow non-bank professional asset managers to fairly compete for the funds of private foundations, university endowments, state and local governments, and other tax-exempt organizations, and to provide these organizations with the broadest possible range of investment choices and improved opportunities to invest in real estate on a diversified basis.

We appreciate this opportunity to comment. If you would like further information, or if we can be of assistance in any way, please do not hesitate to contact us.

Respectfully submitted,

Robert B. Harding
Robert B. Harding

Louis T. Mazawey

MACHINERY and ALLIED PRODUCTS INSTITUTE
1200 EIGHTEENTH STREET, N.W. WASHINGTON, D.C. 20036 202-331-8430

PRESIDENT
CHARLES W. STEWART

VICE PRESIDENT AND TREASURER
THOMAS F. RUSSELL .... Chairman
Federal-Mogul Corporation, Detroit, Michigan

VICE PRESIDENTS
JOSEPH A. BOYD .... Chairman
Harris Corporation, Melbourne, Florida
ROBERT CIZIK .... Chrm. and Pres.
Cooper Industries, Inc., Houston, Texas
DAVID T. KIMBALL .... President
General Signal Corporation, Stamford, Connecticut

SENIOR VICE PRESIDENT
CHARLES I. DERR

VICE PRESIDENT AND CHIEF ECONOMIST
RICHARD R. MacNABB

SECRETARY
FRANCIS W. HOLMAN, JR.

ASSISTANT TO THE PRESIDENT
FRED E. SHAND

STAFF DIRECTOR—INTERNATIONAL
PAUL H. PRATT

SENIOR COUNSEL
WILLIAM J. HEALEY, JR.

STAFF COUNSEL
DONN R. MARSTON

ECONOMIST
A. B. van der VOORT

ASSISTANT TREASURER
MILDRED A. SMITH

EXECUTIVE COMMITTEE
WILLIAM F. ANDREWS .... Chrm. and Pres.
Scovill Inc., Waterbury, Connecticut
JAMES F. BERE .... Chairman
Borg-Warner Corporation, Chicago, Illinois
WENDELL F. BUECHE .... President
Allis-Chalmers Corporation, Milwaukee, Wisconsin
IVAN A. BURNS .... Chairman
ACF Industries Incorporated, New York, New York
A. WILLIAM CALDER .... President
Joy Manufacturing Company, Pittsburgh, Pennsylvania
E. PAUL CASEY .... President
Ex-Cell-O Corporation, Troy, Michigan
W. PAUL COOPER .... Chairman
Acme-Cleveland Corporation, Cleveland, Ohio
J. E. CUNNINGHAM .... Chairman
McDermott International, Inc., New Orleans, Louisiana
CLARK DAUGHERTY .... Chairman
Duracell International Inc., Vero Beach, Florida
THOMAS I. DOLAN .... President
A. O. Smith Corporation, Milwaukee, Wisconsin
EVANS W. ERIKSON .... Chairman
Sundstrand Corporation, Rockford, Illinois
EDMUND B. FITZGERALD .... President
Northern Telecom Limited, Ontario, Canada
T. MITCHELL FORD .... Chrm. and Pres.
Emhart Corporation, Hartford, Connecticut
EDSON I. GAYLORD .... Chrm. and Pres.
The Ingersoll Milling Machine Co., Rockford, Illinois
JAMES A. D. GEIER .... Chairman
Cincinnati Milacron Inc., Cincinnati, Ohio
K. ROBERT HAHN .... Exec. Vice Pres.
Lear Siegler, Inc., Santa Monica, California
THOMAS A. HOLMES .... Chairman
Ingersoll-Rand Company, Woodcliff Lake, New Jersey
LEON C. HOLT, JR. .... Vice Chairman
Air Products and Chemicals, Inc., Allentown, Penn.
JOHN V. JAMES .... Chairman
Dresser Industries, Inc., Dallas, Texas
ROBERT V. KRIKORIAN .... Chairman
Rexnord Inc., Milwaukee, Wisconsin
QUENTIN C. McKENNA .... President
Kennametal Inc., Latrobe, Pennsylvania
DONALD R. MELVILLE .... President
Norton Company, Worcester, Massachusetts
GERALD B. MITCHELL .... Chairman
Dana Corporation, Toledo, Ohio
JOHN C. MORLEY .... President
Reliance Electric Company, Cleveland, Ohio
ALFRED G. MUGFORD .... Exec. Vice Pres.
White Consolidated Industries, Inc., Cleveland, Ohio
ELBERT H. NEESE .... Chrm. and Pres.
Beloit Corporation, Beloit, Wisconsin
WALTER F. RAAB .... Chairman
AMP Incorporated, Harrisburg, Pennsylvania
HENRY D. SHARPE, JR. .... Chairman
Brown & Sharpe Mfg. Co., N. Kingstown, Rhode Island
RICHARD B. STONER .... Vice Chairman
Cummins Engine Company, Inc., Columbus, Indiana
JAMES R. STOVER .... President
Eaton Corporation, Cleveland, Ohio
RAYMOND C. TOWER .... President
FMC Corporation, Chicago, Illinois
WILLIAM G. vonBERG .... Chairman
Sybron Corporation, Rochester, New York
R. J. WEAN, JR. .... Chrm. and Pres.
Wean United, Inc., Pittsburgh, Pennsylvania
JOHN A. YOUNG .... President
Hewlett-Packard Company, Palo Alto, California

October 6, 1983

The Honorable Bob Packwood
Chairman
Subcommittee on Taxation and
  Debt Management
Committee on Finance
United States Senate
SD-221 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman and Members
  of the Subcommittee:

S. 1584: The Proposed "Foreign Tax Credit Conformity Act of 1983"

The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to present to the Senate Finance Subcommittee on Taxation and Debt Management the Institute's views concerning S. 1584, the proposed "Foreign Tax Credit Conformity Act of 1983," as introduced by Senator Danforth on June 29, 1983. We request that our views be entered in full text into the public record of hearings held on S. 1584.

As the Subcommittee may know, MAPI is the national organization of manufacturers of capital goods and allied products. The Institute's member companies conduct business worldwide and, therefore, are directly affected by the foreign tax credit provisions of the U.S. federal income tax law. Inasmuch as the United States taxes the income of U.S. citizens, residents, or corporations wherever earned and utilizes the foreign tax credit mechanism as an offset intended to preclude double taxation, MAPI considers it essential that the credit in fact achieve its purpose and operate to facilitate rather than impede international trade. We also favor initiatives to simplify this area of the Internal Revenue Code consistent with the purposes of eliminating double taxation of foreign-source income and preserving taxpayer equity.

In brief, we support enactment of S. 1584 to eliminate the "double tax detriment" inadvertently introduced into the tax law at the time that Code Section 904(f) was enacted as part of the Tax Reform Act of 1976 for the purpose of eliminating a "double tax benefit." In addition

MACHINERY & ALLIED PRODUCTS INSTITUTE AND ITS AFFILIATED ORGANIZATION, COUNCIL FOR TECHNOLOGICAL ADVANCEMENT, ARE ENGAGED IN RESEARCH IN THE ECONOMICS OF CAPITAL GOODS (THE FACILITIES OF PRODUCTION, DISTRIBUTION, TRANSPORTATION, COMMUNICATION AND COMMERCE) IN ADVANCING THE TECHNOLOGY AND FURTHERING THE ECONOMIC PROGRESS OF THE UNITED STATES to approving the domestic loss recapture item as a mirror-image supplement to Section 904(f), we urge enactment of the carryover and ordering rule changes to conform the foreign tax credit provisions to those of other credits and to facilitate the use of such credits while advancing the causes of uniformity and simplification. More specifically, we recommend approval of S. 1584 to accomplish the following:

1. Recapture domestic losses of a taxpayer in subsequent years in which the taxpayer has domestic income by recharacterizing the subsequent domestic income as foreign-source income, to the extent that domestic losses have served to reduce the foreign tax credit available to the taxpayer.

2. Extend foreign tax credit carryovers from the current five years to 15 years, as in the case of unused investment tax credits, other credits, and net operating losses (NOLs), to allow more time for utilization.

3. Revise the foreign tax credit ordering rules from a last-in/first-out (LIFO) basis to a first-in/first-out (FIFO) basis, as in the case of other credits and NOLs, again to facilitate credit utilization.

Background

Foreign Tax Credit

The United States taxes the income of U.S. citizens, residents, or corporations wherever earned. The foreign tax credit was enacted in 1918 to prevent U.S. taxpayers from being taxed twice on their foreign-source income, once by the source country and again by the United States. The foreign tax credit is intended to allow U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid to a foreign country, but such credits may not be used to offset U.S. tax on domestic income.

Credit Limitation

In order that the foreign tax credit not reduce the U.S. tax on U.S.-source income, a limitation is used to prorate the taxpayer's total U.S. tax liability before tax credits between its U.S.- and foreign-source taxable income. More specifically, the ratio of foreign-source taxable income to total taxable income is multiplied by the total pre-credit U.S. tax to establish the amount of U.S. tax paid on the foreign income and, thus, the upper limit of the foreign tax credit. Although different approaches to such a limitation have been used over the years, Congress made the "overall" limitation mandatory for most taxpayers as part of the Tax Reform Act of 1976.

Foreign Loss Recapture

A foreign loss recapture rule also was established by the Tax Reform Act of 1976. Before enactment, foreign losses of U.S. taxpayers generally had the effect of reducing the U.S. tax base by decreasing the worldwide taxable income on which the U.S. tax is imposed. If the taxpayer later received income from abroad on which foreign tax was paid, a foreign tax credit was allowed for the full amount of the foreign tax. In some instances, this created an incidental benefit because no U.S. tax was imposed on the subsequent year's income to the extent of foreign taxes paid on the income, even though the earlier losses had reduced U.S. tax liability on U.S.-source income.

Congress responded to the overall foreign loss issue by requiring that losses from foreign operations and, thus, the tax benefit derived from the deduction of such losses should be recaptured by the United States when the taxpayer subsequently derived income from abroad. This is accomplished under Code Section 904(f) by treating a portion of foreign income as income from domestic sources. The effect of the recharacterization is to reduce the foreign tax credit limitation in one or more subsequent years and, therefore, the amount of U.S. tax that can be offset by foreign tax credits in such subsequent years. At the time of the enactment, no attention was given to the double tax burden that may be experienced by a U.S. taxpayer in some circumstances where there is foreign source income but an overall domestic loss--an omission that persists to date but would be cured by S. 1584.

Carryovers and Ordering

Under existing law, foreign taxes which cannot be claimed currently as a tax credit may be carried back successively to the second and first preceding taxable years and then forward to the first, second, third, fourth, and fifth succeeding taxable years. Pursuant to the ordering rule, current foreign taxes are credited against U.S. tax before foreign taxes carried from other years are credited against U.S. tax.

The Proposal, S. 1584

S. 1584 would establish a domestic loss recapture rule the operation of which would be similar to the operation of the present foreign loss recapture rule with the exception that subsequent domestic income would be recharacterized as foreign-source income to increase the foreign tax credit limitation and, potentially, the amount of utilizable foreign tax credits, effective for taxable years beginning after 1981. The bill also would increase the foreign tax credit carryover period from five years to 15 years for excess foreign tax credits that arise in taxable years beginning after 1978. Finally, S. 1584 would provide a new FIFO ordering rule for utilization of foreign tax credits under which credits would generally be utilized in the order in which they arise, effective with respect to taxable years beginning after 1981.

Comments on S. 1584

Domestic Loss Recapture

Perhaps the single, most important feature of S. 1584 is Section 2 which would amend Code Section 904(f) to provide for the recapture of overall domestic losses as well as overall foreign ones. When Congress enacted Section 904(f) in 1976, it was addressing a situation wherein U.S. taxpayers with foreign-source income were occasionally enjoying double benefits. This occurred when a taxpayer had overall foreign losses in one year--thereby reducing the taxpayer's worldwide income on which the U.S. income tax is based--followed by profitable foreign operations generating foreign tax credits that once again would reduce U.S. taxes. In dealing with this, Congress overlooked the need for a similar provision for the recapture of overall domestic losses to avoid double taxation.

Double-tax consequences.--This omission has gained increasing attention since enactment, but the implications have become particularly ominous during the prolonged economic slowdown of recent years. As indicated in the extension of remarks by Senator Danforth accompanying introduction of S. 1584, it can be demonstrated that the absence of the mirror-image provision proposed in the bill subjects certain taxpayers to taxation at extremely high rates (e.g., 69 percent in Senator Danforth's example, see below). Taxpayers that experience this phenomenon typically have sizable domestic losses coupled with profitable foreign operations in relatively high tax rate jurisdictions, followed in a subsequent period by income from both sources. A number of the "basic" industries in this country recently have encountered this form of double taxation, but the inequity can be experienced by any taxpayer with the proper--albeit unfortunate--set of circumstances.

Further as to double taxation, consider in the following simplified examples how a taxpayer with foreign source income and an overall domestic loss would be treated, first, under current law and, second, under S. 1584:

Example 1 (Current Law)

	Year 1	Year 2	2-Year Total
Foreign-Source Income (Loss)	$100	$100	$200
U.S.-Source Income (Loss)	(100)	100	0
U.S. Taxable Income	0	200	200
Foreign Tax Paid (46 Percent)	46	46	92
Pre-Credit U.S. Tax (46 Percent)	0	92	92
Foreign Tax Credit Utilized	0	46 /1	46
Net U.S. Tax Paid	0	46	46
Excess Foreign Tax Credit	46	0	46

Example 2 (S. 1584)

	Year 1	Year 2	2-Year Total
Foreign-Source Income (Loss)	$100	$100	$200
U.S.-Source Income (Loss)	(100)	100	0
U.S. Taxable Income	0	200	200
Foreign Tax Paid (46 Percent)	46	46	92
Pre-Credit U.S. Tax (46 Percent)	0	92	92
Foreign Tax Credit Utilized	0	92 /2	92
Net U.S. Tax Paid	0	0	0
Excess Foreign Tax Credit	46	(46)	0

In Example 1 (Current Law), the taxpayer has no U.S.-source taxable income for the two-year period, but pays $46 in U.S. tax and $92 in foreign tax while accruing $46 of excess foreign tax credits--an effective tax rate of 69 percent ($138 of tax payments divided by $200 of taxable income) for the two-year period. In Example 2 (S. 1584), the taxpayer pays no U.S. tax and accrues no excess foreign tax credits for the two-year period because the domestic loss has been recharacterized as foreign-source loss for foreign tax credit limitation purposes. This is the same result as would obtain in Example 1 if the taxpayer had $100 of foreign-source taxable income in each year but no U.S.-source taxable income at all, in other words, equivalent circumstances for the two-year period.

1/ Foreign tax credit limitation: Foreign source income ($100)/ total taxable income ($200) multiplied by pre-credit U.S. tax ($92) equals $46.

2/ Foreign tax credit limitation: Foreign source income ($200, because the domestic income in Year 2 is recharacterized as foreign-source income/total taxable income ($200) multiplied by pre-credit U.S. tax ($92) equals $92.

Symmetry, prevention of inequity, etc.--In our judgment, the domestic loss proposal calling for recharacterization of subsequent domestic income for foreign tax credit limitation purposes is needed to establish symmetry in the rules governing losses under Code Section 904(f) in order to prevent inequity. Whether the proposal is viewed as technical or substantive in nature is less important to Congress' disposition of the matter than a simple recognition that (1) there has been an omission adversely and unfairly affecting some taxpayers, and (2) something must be done about the omission to avert serious inequity. Although there would be some revenue cost associated with the proposed "repair" of Section 904(f), the amount certainly is not intolerable and cost should not be an impediment to correcting tax policy error and inequity.

"Conceptual merit"; the annual accounting period.--In that regard, we note with interest that the Department of the Treasury, while "unable to support" S. 1584, noted that the domestic loss recapture rule has "conceptual merit." Also, in the words of Treasury Deputy Assistant Secretary Ronald A. Pearlman--

> . . . Perhaps when Congress was addressing the potential abuse relating to double benefits with respect to foreign losses, it also should have considered the possibility that the reverse situation might arise and require attention. . . .

However, Treasury went on to argue that the foreign tax credit originally was enacted only to prevent the double taxation of foreign-source income realized in a particular year. This disregards the fact that Congress saw fit to dismiss the annual accounting period in enacting Code Section 904(f) itself. Moreover, it should be apparent that a taxpayer now carrying an effective tax rate of 69 percent on income taxed by two countries with equal rates of 46 percent is indeed burdened by double taxation.

Capital flow.--Treasury has supported--and we suspect Congress ultimately will enact--another bill, S. 1557, to repeal the 30 percent withholding tax on certain interest payments to nonresident aliens and foreign corporations. Part of the reason for this support is to improve the access of U.S. businesses to capital markets abroad, or, put another way, to facilitate the flow of capital into this country from abroad. We suspect that S. 1584 would have the same effect for companies that have had profitable foreign operations while experiencing overall domestic losses because the price to them of repatriating income often has been double taxation, which S. 1584 is intended to correct. We also see merit in the contention that the domestic loss recapture of S. 1584 would help taxpayers so situated to recover indirectly in subsequent profitable years some of the benefits of Accelerated Cost Recovery System deductions that have been unavailable in years in which they simply contributed to overall domestic losses.

Carryovers and Ordering

In addition to domestic loss recapture for foreign tax credit limitation purposes, Section 3 of S. 1584 would amend the credit carryover period to allow a 15-year carryover and would change the ordering rule from a LIFO basis to a FIFO basis. Although the three provisions possibly could be dealt with separately, they complement one another and should be treated as a unit to address the existing inequities and to conform the credit to other tax law that already has been updated.

Carryover displacement effect; lengthening; conformity.--As to the carryover, it stands to reason that the existing five-year carryover for the foreign tax credit is less conducive to credit utilization then the 15-year period that has been proposed. This is particularly so because net operating loss (NOL) carrybacks and carryforwards /1 displace taxable income of the years to which they are carried, setting credits free to be added to the excess credit position already established and, thereby, increasing the likelihood that the short credit carryover period will cause some amounts to expire unused. This "displacement" factor was the reason for adding the "forward only" election to the NOL carryover, but the election is of little use where the taxpayer already has little or no "cushion" in his foreign tax credit limitation due to operations in relatively high-tax countries. Other tax credits are accorded a 15-year carryover and Congress should end the anachronistic arrangement now applicable to the foreign tax credit.

In that connection, we note that the investment tax credit (ITC) carryover was extended to 15 years mainly to prevent a loss in the value of ACRS to taxpayers attributable to ITCs expiring unused. How, one wonders, is anyone to distinguish foreign tax credits from ITCs for this purpose? ACRS benefits are as surely eroded by expiring foreign tax credits as by any other dollar-for-dollar offsets to the income tax that are going unused.

Ordering conformity; matching.--The ordering issue seems fairly straightforward to us in that the LIFO approach now in effect is more likely to cause credits to expire unused than is the FIFO basis. Also, FIFO is now used for the ITC, and the uniformity implicit in S. 1584 would simplify matters, however modestly. As to inconsistency of FIFO with the "matching" principle inherent in the foreign tax credit system, we acknowledge that under FIFO ordering foreign tax credits of particular years might not be matched with the pre-credit U.S. tax on the current income that gave rise to the credits to the extent that

---

1/ NOLs can be carried back three years and then forward up to 15 years, or, at the election of the taxpayer, can only be carried forward up to 15 years.

credit carryovers equaled or exceeded the pre-credit U.S. tax. However, we do not see that anything is sacrificed by this lack of tidiness in matching, whereas FIFO would improve credit utilization. In fact, matching already is relegated to a secondary role under Code Section 904(f). Also, matching already is disregarded for foreign tax credit purposes to the extent that the overall limitation is mandatory for most taxpayers.

Concluding Comment

Unlike most tax legislation under discussion at this time, S. 1584 does not purport either to raise revenues; lower them; overhaul the Code; advance social causes; "incentivize" certain forms of behavior; penalize other activities; or achieve lofty new goals of other sorts through manipulation of the tax law. Instead, S. 1584 has been introduced to correct a known inequity principally affecting taxpayers that have been faced with domestic business adversity while simultaneously experiencing profits on foreign income in jurisdictions imposing income taxes at relatively high rates. This combination of circumstances has cast light on both the incompletely considered "reforms" that exist in current Code Section 904(f) and the out-of-date carryover and ordering rules otherwise subjecting such taxpayers to double taxation. The remedy, S. 1584, is before the Subcommittee, and we trust that due attention will be given to it with a view to enactment in the current Congress.

Respectfully,

Charles Stewart

President

k.

NAM
National Association
of Manufacturers
Taxation and Fiscal Policy Department

October 17, 1983

1983 OCT 18 PM 3:34

The Honorable Robert Packwood
Chairman
Subcommittee on Taxation and Debt Management
259 Senate Russell Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

The purpose of this letter is to express the support of the National Association of Manufacturers for S.1584, The Foreign Tax Credit Conformity Act of 1983, which was the subject of hearings before The Finance Subcommittee on Taxation and Debt Management on September 26, 1983. Accordingly, it is requested that this letter be included in the hearing record for that occasion.

Under current law taxpayers with an overall foreign source loss are required to "recapture" that loss in future years for purposes of the foreign tax credit limitation. However, a taxpayer with an overall domestic loss and foreign source income has a permanent impairment of the foreign tax credit limitation by being limited to the lower of the U.S. tax on foreign source income or the total tax before credits.

The net effect, under current economic conditions, is that capital intensive companies in a domestic loss situation are penalized by bringing home foreign profits which would be available for investment in new productive capacity. S.1584 addresses this problem by permitting taxpayers to use foreign tax credits lost as a result of domestic losses, if the domestic losses are earned out in future years. Passage of this legislation would provide more equal treatment of U.S. and foreign income/loss, thereby reducing the incidence of double taxation.

Other sections provide for an increase of the foreign tax credit carryover period from five to fifteen years for excess foreign tax credits that arise in taxable years beginning after 1978; and a first in-first out rule for foreign tax credit carryovers.

The NAM believes that the treatment of foreign tax credits should be updated to promote the repatriation of foreign profits to finance new and more productive capital purchases.

We urge your support of this bill.

Sincerely,

Robert A. Ragland
Director of Taxation

RAR/bma

1776 F Street, N.W.
Washington, D.C. 20006
(202) 626-3700

The Nature Conservancy

1800 North Kent Street, Arlington, Virginia 22209
(703) 841-5300

September 30, 1983

The Honorable Bob Packwood
United States Senate
Russell Senate Office Building
Room SR-259
Washington, D.C. 20510

Attention: Mr. John Colvin, Legislative Director

Dear Senator Packwood:

The Nature Conservancy has recently learned of your introduction of Senate Bill S-1815 to amend the Internal Revenue Code to provide tax exemption for a real estate holding corporation which is formed to acquire and manage property for more than one 501(c)(3) charitable organization.

We commend your introduction of this legislation and wish to urge its passage by the Congress.

The Conservancy, like many small and medium sized charitable organizations, wishes to diversify its financial investments and endowment funds to include income-producing real estate. However, we are not large enough, nor do we have the investment expertise, to assemble diversified real estate holdings, which would include income-producing industrial, commercial and residential properties. In our search for appropriate real estate investment vehicles, we have found very few appropriate vehicles for an organization of our size. On the other hand, the large pension funds appear to have such opportunities that are not available to other charities. The enactment of your bill would redress this inequity and afford the opportunity to many charities across the United States to improve their performance towards the public welfare by means of a more balanced long-term investment portfolio.

We also strongly concur with the provision in S-1815 which would allow for the real estate investments to be made through the traditional vehicle of debt financing without triggering taxation on unrelated business income. Again, this provision would simply put public charities on equal footing with the pension plans.

Thank you for your efforts to improve opportunities for non-profit, charitable organizations to invest in a balanced, diversified portfolio of real estate.

Sincerely,

L. Gregory Low
Executive Vice President

LGL:bs

THE NATURE CONSERVANCY

100% Recycled Paper

RICHARD KING MELLON FOUNDATION
525 WILLIAM PENN PLACE
PITTSBURGH, PENNSYLVANIA 15219

September 22, 1983

The Honorable Bob Packwood
Senator of the United States
Russell Senate Office Building
Room SR-259
Washington, DC 20510

Attention: Mr. John Colvin, Legislative Director

Dear Senator Packwood:

It has come to our attention that on Monday, September 26, 1983, hearings will begin in the Subcommittee on Taxation and Debt Management with regard to Senate Bill S-1815 to amend the Internal Revenue Code of 1954 to exempt from taxation corporations which acquire and manage real property for certain other exempt organizations.

It is the purpose of this letter to go on record for these hearings to endorse the proposed Senate Bill S-1815. Income-producing real estate investments provide a prudent method of investment portfolio diversification. The Richard King Mellon Foundation made a thorough search and examination of the available investment managers and vehicles. During our search, we found very few investment opportunities available to us because the majority of real estate managers offer pooled real estate funds for pension clients and, unfortunately most of these pools are not permitted to commingle pension and charitable assets. For this reason, real estate commitments to date by the Richard King Mellon Foundation are not as significant as we intend them to be. Passage of your legislation would pave the way for numerous real estate managers to form new vehicles and thus provide charities with a wide selection of real estate managers.

In addition to providing public charities with the proper medium for real estate investments, there are also, in our opinion, other favorable aspects of the proposed legislation. The proposed Bill S-1815 would permit foundations to indirectly become equity owners of leveraged real estate without incurring the unrelated business income tax. As you are aware, the Internal Revenue Service has already accorded pension funds this status. We view this as a very significant factor from an investment standpoint because the use of debt (particcularly in today's climate of high real interest rates when an investor can assume existing debt at lower rates) can enhance investment returns. We strongly recommend that this portion of the legislation not be deleted during the hearings.

Also consider the economies and efficiencies to be realized by a university, for example, who may have the real estate investments of its pension plan with a selected manager who does not have the proper vehicle to accept real estate investments from the institution's endowment. The university must then consider different managers for its two pools of investment capital. Your legislation, however, would correct this inconsistency and permit institutions to streamline the administration of their real estate investments.

We extend to you our sincere appreciation for your efforts in introducing this legislation. Its passage would be advantageous to universities, colleges, symphonies, hospitals, foundations, and other charitable organizations with endowments too small to permit a prudent, diversified real estate portfolio.

Sincerely yours,

Robert B. Burr, Jr.

Robert B. Burr, Jr.
Secretary

ROBERT A. LADIG
Staff Vice President
Taxes

September 15, 1983

The Honorable Bob Packwood, Chairman
Subcommittee on Taxation and Debt Management
259 Senate Russell Office Building
Washington, DC 20510

Re: S. 1584
Hearing Date: September 26, 1983

Dear Senator Packwood:

I am writing to let you know of Scott's interest in S. 1584, the "Foreign Tax Credit Conformity Act of 1983," which your subcommittee will soon be addressing.

This bill conforms the treatment of overall domestic losses with the treatment of overall foreign losses and conforms the foreign tax credit carryover and ordering rules with similar investment credit and net operating loss rules. Apparently it was an oversight not to conform the foreign tax credit carryback rules with the 3-year investment credit and net operating loss carryback rules.

	Carryback/Carryover Summary		
	Foreign Tax Credit ("FTC")	Investment Tax Credit ("ITC")	Net Operating Loss ("NOL")
Present Law:			
Carryback	2 years	3 years	3 years
Carryover	5 years	15 years	15 years
After S. 1584:			
Carryback	2 years	3 years	3 years
Carryover	15 years	15 years	15 years

SCOTT PAPER COMPANY • SCOTT PLAZA, PHILADELPHIA, PENNSYLVANIA 19113 • (215) 522-5381

As you know, the carryback/carryover provisions have a significant practical effect: they are countercyclical in impact. Without such a mechanism, tax liabilities would be determined solely on the basis of results in isolated taxable years without regard to the longer term effects of business cycles and recessionary periods such as the one we experienced the last two years. This would discriminate against taxpayers whose incomes vary widely versus those who are less affected by business cycles and general economic conditions.

Suggestion: In the interest of obtaining the broadest possible support for the Bill by presenting a complete technical conforming amendment, it is desirable to make the FTC carryback 3 years.

Solution: This can be accomplished quite simply by modifying section 3(b) of the Bill as indicated on Appendix A. This modification provides that amended Section 904(a)(3)(A) of the Code permits a 3-year FTC carryback instead of a 2-year carryback.

I hope you find this helpful. We would be delighted to answer any questions or provide additional information to you or your staff concerning this change which I think is consistent with the intent of the Bill.

Sincerely yours,

RAL/njm

cc: Roderick A. DeArment, Chief Counsel
Committee on Finance

"(B) OVERALL DOMESTIC LOSS DEFINED.—For purposes of this subsection, the term 'overall domestic loss' means the amount by which the gross income for the taxable year from sources within the United States for such year, including the amount, if any, that is treated as income from sources within the United States for such taxable year under subparagraph (1), is exceeded by the sum of the deductions properly apportioned or allocated thereto, to the extent such loss offsets income from sources without the United States for the taxable year, except that there shall not be taken into account any loss for such year which arises from fire, storm, shipwreck, or other casualty, or from theft, to the extent such loss is not compensated for by insurance or otherwise.".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to taxable years beginning after December 31, 1981.

SEC. 3. EXTENDED CARRYOVER PERIOD FOR EXCESS FOREIGN TAX CREDITS; ORDERING RULE FOR FOREIGN TAX CREDIT.

(a) CARRYOVER PROVISION FOR EXCESS CREDITS ARISING IN 1979 THROUGH 1981.—Subsection (c) of section 904 is amended by inserting at the end thereof the following new sentence: "In the case of an amount deemed by this subsection to be an excess tax paid with respect to a taxable year beginning after December 31, 1978, and ending before January 1, 1982, the first sentence of this subsection shall be applied by substituting 'in each of the 15 succeeding taxable years' for 'in the first, second, third, fourth or fifth succeeding taxable years,' in the first sentence.".

(b) Carryback, CARRYOVER AND ORDERING RULE PROVISIONS FOR CREDITS ARISING AFTER 1981.—Subsection (a) of section 904 is amended to read as follows:

"(a) GENERAL RULE.—

"(1) FIRST-IN-FIRST-OUT RULE.—The amount of the credit allowed by section 901(a) shall be an amount equal to the sum of—

"(A) the foreign tax credit carryovers carried to such taxable year,

"(B) the amount of the credit determined under section 901(a) for such taxable year, plus

"(C) the foreign tax credit carrybacks carried to such taxable year,

and subject to the limitations imposed by paragraphs (2), (3), (4) and (5). The credits allowable under subparagraph (A) shall be used before the credits allowable under subparagraphs (B) and (C), and the credits allowable under subparagraphs (A) and (B) shall be used before the credits allowable under subparagraph (C).

"(2) LIMITATION IN TAXABLE YEAR.—The total amount of credit taken under section 901(a) in paragraph (1) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year. For purposes of the preceding sentence, in the case of an individual, the entire taxable income shall be reduced by an amount equal to the zero bracket amount.

"(3) CARRYBACK AND CARRYOVER OF EXCESS TAX PAID.—If the sum of the amount of the foreign tax credit carryovers to the taxable year under paragraph (1)(A) plus the amount determined under paragraph (1)(B) for the taxable year exceeds the amount of the limitation imposed by paragraph (2) for such taxable year (hereinafter in this subsection referred to as the 'unused credit year'), such excess attributable to the amount determined under paragraph (1)(B) shall be—

"(A) a foreign tax credit carryback to each of the ~~2~~ 3 taxable years preceding the unused credit year, and

"(B) a foreign tax credit carryover to each of the 15 taxable years following the unused credit year and,

subject to the limitations imposed by paragraphs (4) and (5), shall be taken into account under the provisions of paragraph (1) in the manner provided in such paragraph. The entire amount of the unused credit for an unused credit year shall be carried to the earliest of the ~~17~~ 18 taxable years to which (by reason of subparagraphs (A) and (B)) such credit may be carried and then to each of the other ~~16~~ 17 taxable years to the extent, because of the limitations imposed by paragraphs (4) and (5), such unused credit may not be taken into account under paragraph (1) for a prior taxable year to which such unused credit may be carried.

"(4) LIMITATION ON CARRYBACKS.—The amount of the unused credit which may be taken into account under paragraph (1)(C) for any preceding taxable year shall not exceed the amount by which the limitation imposed by paragraph (3) for such taxable year exceeds the sum of—

STATEMENT OF
ARCHIBALD E. MACKAY
SENIOR VICE PRESIDENT AND
CHIEF FINANCIAL OFFICER
THE SINGER COMPANY
FOR THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE
September 26, 1983
"S. 1584--The Foreign Tax Credit Conformity Act of 1983"

As Senior Vice President and Chief Financial Officer of The Singer Company, I appreciate this opportunity to explain to you why S. 1584, The Foreign Tax Credit Conformity Act, will promote investments and jobs in the United States and will create equity in the Internal Revenue Code. In this regard, I strongly suggest the enactment of S. 1584 in its present form.

The Singer Company produces electronic systems for the aerospace industry and manufactureres and sells consumer durables. It presently has annual sales of over $2.5 billion and employs over 57,000 people. The Company has substantial operations overseas and has historically repatriated funds from overseas locations for investment in the United States. As a result of the recent recession, Singer and certain other basic industry companies incurred significant domestic losses in 1982 but generated profits overseas.

Because of these circumstances, Singer and other companies have become the unfortunate victims of a foreign tax credit provision in the Internal Revenue Code which we believe is inequitable in its present form.

The Foreign Tax Credit

The United States is one of the countries that imposes tax on a United States company's worldwide income rather than limiting the tax to income generated within the borders of its own country. Therefore, when a United States corporation makes a profit outside its borders, it more than likely will be taxed both by the United States and the foreign country within which it is doing business.

As a basic principle, Congress and the Administration have always attempted to provide a sense of fairness with regard to a corporation's tax burden, regardless of whether the income is generated offshore or in the United States. The cornerstone for implementing this sense of equity is the foreign tax credit, which allows a domestic company to take a credit against the

U.S. tax for foreign taxes paid on overseas earnings. In essence, the foreign tax credit prevents "double taxation" of a company's earnings.

However, corporations are subject to restrictions on how much foreign tax they can take as a credit in any one year. A major limitation is that a company can only use foreign tax credits to offset U.S. taxes imposed on foreign source income. Moreover, the foreign tax credit allowed in any one year cannot exceed the amount of U.S. tax on the taxpayer's overall (domestic and foreign) income. These two limitations are represented by the following ratio:

$$\begin{array}{c}\text{Foreign Tax}\\\text{Credit Allowed}\end{array} = \frac{\text{Foreign Source Income}}{\text{Worldwide Income}} \times \begin{array}{c}\text{U.S. Tax}\\\text{Liability}\end{array}$$

In a situation where a domestic company incurs losses in the United States but makes a profit overseas and pays foreign taxes on those overseas profits, the company will likely incur "excess" foreign tax credits. To illustrate, suppose a United States corporation loses $100 domestically, but makes $200 overseas, on which it pays a foreign tax at a 46% rate, or $92. The worldwide taxable income of the Company is $100 ($200 - $100). The U.S. tax before credits is $46 (46% X $100). The Company can only use $46 of the $92 in foreign tax credits to offset the U.S. tax. The remaining $46 are treated as excess foreign tax credits.

Present law allows the $46 in excess foreign tax credits that cannot be used currently to be carried back two years and carried forward five years to offset U.S. tax in those particular years. However, the carryovers and carrybacks can only be used after foreign taxes generated in the carryforward or carryover years are first used to offset the U.S. tax.

Moreover, as previously explained, foreign taxes can only be used to offset U.S. taxes imposed on foreign source taxable income. The combination of these tax credit rules often make it quite difficult for a company to use excess credits before they expire. As a result, a company can be effectively subjected to double taxation when it:

1. initially incurs losses domestically but makes profits overseas (as in the above illustration),

2. subsequently returns to profitability in the United States; and

3. cannot use excess foreign tax credits before they expire because of continuing high foreign taxes.

The double tax occurs because the foreign source income (after deducting U.S. losses) in the initial year is taxed both in the United States and by the foreign country, and these foreign taxes not utilized to reduce U.S. tax on the foreign source income are never recouped as credits against U.S. income. See the attached Exhibit for an illustration and further details.

The Singer Company is one of the domestic corporations with conditions similar to that in the Exhibit. As previously mentioned, Singer incurred domestic losses while generating profits overseas and, consequently, has significant excess foreign tax credits. The company is returning to domestic profitability but it is highly unlikely that it will be able to use its excess foreign tax credits before they expire. Thus, on a cumulative basis, Singer would be subject to the "double taxation" not intended by Congress.

The tax credit rules, as they exist today, may force United States corporations with excess tax credits to favor overseas investment in low tax countries in order to generate foreign source income and absorb the excess credits. This incentive toward investing overseas is certainly inconsistent with public policy, which is to encourage investment domestically to generate jobs for United States citizens and modernize our productive capacity. Clearly, a revision in tax policy which changed this situation would be in the best interests of the country since it would enhance our worldwide competitive position and encourage domestic job formation.

Proposed Bill

S. 1584, The Foreign Tax Credit Conformity Act of 1983, will at least partially alleviate the problem explained above, by allowing foreign tax credits to be carried forward 15 years instead of only five years. This provision simply places the foreign tax credit carryforward on a parity with the investment tax credit and net operating loss carryforwards. It does not represent a serious divergence from current tax law, but rather conforms the foreign tax credit provisions with the other tax credit rules.

Also, under present law, the current foreign tax credit must be used first, followed by carryforwards, and then by carrybacks. S. 1584 will change the ordering rules so that the earliest foreign tax credits will be used first; this more equitable system will further reduce the potential for a corporation losing the ability to utilize credits. This "FIFO" ordering concept is not new; similar ordering rules were recently enacted for investment tax credits.

Finally, S. 1584 will allow companies to recharacterize domestic income in future years as foreign source income in an amount equal to its domestic losses that offset foreign income in 1982 and in subsequent years. Thus in the example previously given, where a company had $100 of domestic losses, it will be able to treat $100 of domestic income in a subsequent year as foreign source income, for which it can utilize the foreign tax credit carryovers.

This "recharacterization" concept is not unique; it, in fact, develops symmetry with Section 904(f) of the Internal Revenue Code, which was added by the 1976 Tax Reform Act.

Section 904(f) was enacted to prevent a double tax benefit from foreign losses. This "double tax benefit" occurred when, in year one, a company incurred a foreign loss which offset domestic income and reduced the U.S. tax liability. For year two, the company might have foreign income that attracted foreign tax credits. Accordingly, the company enjoyed a reduced U.S. tax in the first year and a foreign tax credit against U.S. taxes in the following year.

Section 904(f) treats subsequent foreign source income up to the amount of the prior foreign source loss as domestic income. Inasmuch as the foreign tax credits can only be used against foreign source income, the tax credits in year two can no longer be used to offset U.S. income.

Proposal S. 1584 is the corollary of Section 904(f); its purpose is to prevent double taxation from domestic losses rather than to prevent double tax benefits from foreign losses.

Conclusion

It is evident that the proposed bill S. 1584 does not give birth to any unique concepts; it simply engenders a further sense of fairness and develops conformity within the Code. Even more important, it will put companies with excess credits in an improved position to invest in the United States and, thereby, promote domestic job formation. For these reasons, I strongly urge that the bill be passed in its present form.

EXHIBIT I

Ilustration of company that (1) has domestic losses and foreign profits in inital year, (2) returns to domestic profitability in a subsequent year, and (3) cannot use the excess foreign tax credits generated in the first year. (See footnote on following page.)

	Year 1	Year 2	Cumulative
Domestic Income	(100)	100	0
Foreign Source Income	200	200	400
Worldwide Income	100	300	400
U.S. Tax before foreign tax credits (46% rate)	46	138	184
Foreign tax paid (46% rate)	92	92	184
Foreign tax credit used to offset U.S. tax	46[A]	92[B]	138
Net U.S. tax paid	0	46	46
Total Tax Paid	92	138	230
Unused Excess Foreign Tax Credit	46	--	46

A.B. See calculations on following page.

A
$$\frac{\text{Foreign Source Income}}{\text{Worldwide Income}} \ \text{X} \ \text{U.S. Tax}$$

$$\frac{\$200}{\$200 - \$100} \ \text{X} \ \$46 \text{ (limited by U.S. tax)} = \$46$$

B
$$\frac{\text{Foreign Source Income}}{\text{Worldwide Income}} \ \text{X} \ \text{U.S. Tax}$$

$$\frac{\$200}{\$200 \ \text{X} \ \$100} \ \text{X} \ \$138 \ = \ \$92$$

Over the two year period, the company has cumulatively earned worldwide income of $400, all of which is foreign sourced. However, the company has paid net U.S. tax of $46, in addition to foreign taxes of $184, for a total of $230. The total paid should be 46% of $400, or $184. The difference between the $230 and the $184 (or $46) represents the "double tax".

Footnote

For purposes of simplicity, the schedule includes only one carryover year after the year the excess credits are generated. However, the net effect will be exactly the same if we assume the numbers in the two carryback and remaining four carryover years are substantially similar to year 2. Under this assumption, the $46 of unused foreign tax credit will expire, and the company will have effectively paid a double tax.

STATEMENT OF LARRY AKEY
PRESIDENT, THE SYNANON CHURCH
BEFORE THE
TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE
OF THE
SENATE COMMITTEE ON FINANCE

Mr. Chairman:

I appreciate the opportunity to submit this statement in support of S.1826 - "Hunger Relief Incentives Tax Act of 1983." In addition to my position as the President of The Synanon Church, I am a member of the Board of Directors of The Synanon Distribution Network, and it is on behalf of the Network that I am submitting this statement.

The Synanon Distribution Network wholeheartedly endorses and supports Senator Danforth's legislation entitled the "Hunger Relief Incentives Tax Act of 1983" and encourages you to recommend its passage to the full Senate. We believe this legislation, when enacted into law, will significantly increase the flow of donated food products to people in need. Given the opportunity, we would recommend expansion of the incentives in the legislation to include non-food product (and the transportation of non-food product), certain processing of food product, and allowance for deducting either: (a) the fair market value of the product, or (b) twice the donor's cost basis of the product, whichever is the lesser amount.

The Synanon Distribution Network

Since 1977, representatives of The Synanon Distribution Network have made many thousands of calls requesting product from businesses and have channeled over $69 million (estimated retail value) of goods to qualified charitable groups. We believe we have more direct experience in soliciting product contributions and in placing product donations with charitable groups than any other organization in the country. The Network has distributed millions of pounds of food, including meat, fish, cheese and other dairy products, fresh, frozen and canned fruit and vegetables, bakery products, juices, drinks, processed foods such as frozen pizza, sauces, condiments, cereals, ice cream and other desserts. Other product distributed in massive quantities includes: tons and tons of clothing, shoes, building materials, medical supplies, office equipment, food service equipment, furniture and toys.

All these items have been distributed to nonprofit tax-exempt organizations for their charitable purposes -- for the direct benefit and use by the ill, needy or children. Groups receiving goods have included all types of organizations: youth groups, senior citizens groups, feeding programs, missions, halfway houses, rehabilitation programs, day care centers, food banks, groups sponsored by churches, and groups sponsored by governmental agencies. Product has been distributed in more than half of the states of the United States, and product has been shipped overseas.

The Synanon Distribution Network operates from a philosophical base that includes a belief in the principles of "self reliance" as expressed in Ralph Waldo Emerson's essay of that name. Our objective is to help people in need become more self-sufficient by becoming involved in the process of helping themselves (and others) through "hands on" involvement in distribution whenever possible. To this end, we encourage groups receiving product to involve the ultimate recipients in the transportation, sorting, handling and distribution of product, and we also encourage the assessment of handling fees when cash costs have been incurred. Our experience with handling charges indicates that goods are moved more expeditiously and responsibly when they have a "cash investment value" to the distributor and recipient -- even though very minor when compared to the actual market value.

Several years ago we became aware of the following statistic: prior to the great depression, over 50% of the social welfare needs of this country were met by the private sector. Today, only about 1% of such needs are handled by the private sector -- the rest is provided by the Government. One of the goals of The Synanon Distribution Network is to build and restore private sector involvement and to reduce the Government's role in taking care of the less fortunate in our society.

Recent History of the Law and Its Effect

American businesses and individuals have always been supportive of volunteerism and charitable efforts. From colonial times, when "barnraising" events were organized for neighbors whose barns had been destroyed by fire, to modern times with the thousands of nonprofit charitable groups which are supported with donations of time and money.

Prior to 1969, businesses were allowed to claim a charitable contribution deduction for the fair market value of product donated to qualified charities. Then, partially because of some abuses, the law was changed to allow the donor to deduct only his cost basis in the product. The abuse of the pre-1969 law occurred when a product that might only cost $.20 to produce, but with a fair market value of $1.00, was donated with the result that the donor actually reduced his taxes more than it cost him to produce the product. Unfortunately, the change in the law reduced the incentive for all businesses to donate product, with the result that after 1969, product donations dropped sharply.

The Tax Reform Act of 1976 restored some of the incentive taken away in 1969. It provided that the donor could deduct the cost, plus 50% of the normal profit that would have been realized had the product been sold -- with an upper limit to the deduction of twice the cost of the product. This change introduced a severe complication in that the law is now difficult to explain and to understand, and many businesses have failed to use it just because they don't understand it.

Synanon Distribution representatives have spent many,

many hours attempting to explain the law, with the frequent result that a businessman says, "I'll have to get my tax accountant in to help me understand this." They are reluctant to use a law that is difficult to understand for fear that someday the IRS may disallow the deduction and they will have given away the product and will get no charitable deduction from their taxes.

The Need for Incentives to Donate

The experience of The Synanon Distribution Network over the past six years indicates that greater incentives are needed to encourage businesses to donate more product. We recommend a full restoration of the "fair market value" deduction with a limit of twice the cost basis of the product. We also recommend a similar deduction for the donation of essential services, including certain food processing and transportation of donated product. The law must also be made more easy to understand.

We believe that allowing businesses to deduct the fair market value of goods donated (with the limit of twice the cost), is an easy to understand concept, and also gives more fiscal incentive for low margin industries, such as the food industry, to donate product. With this change, the "best" a company could do (considering current combined state and federal tax rates) would be to donate product at little or no net cost to its owners. On the other hand, for the cost of the lost tax revenues, the needy would receive product which would have a value of at least three times (and by my analysis about four times) the value of the lost revenue. Since most donors are manufacturers and/or wholesalers, the "fair market value" we are talking about is the wholesale price, meaning that the retail value is even greater.

An added benefit of an increased deduction allowance is that firms that produce more product for the "donation market" will be able to maintain higher levels of employment and equipment utilization during slack periods. Fewer people unemployed during these times will mean fewer people needing assistance.

Transportation and Processing

We strongly encourage the provision in S.1826 providing for a charitable deduction for the donation of transportation services for donated foods. Transportation is frequently the biggest cash cost factor in distribution. Due to the lack of such a deduction today, trucks and containers often are "deadheaded" empty on the same routes that are needed to transport food. Often groups to whom we are able to offer product must turn the product down because they can't afford to ship it in.

In addition to the transportation problem, much food that could be distributed often goes to waste because it cannot be preserved quickly at a reasonable expense. A charitable allowance for food processors for the conversion of fresh food into frozen, canned or dried form, and for temporary storage, would be a very positive development. At this time, there is no incentive at all for the donation of these services, so consequently, they are rarely donated. Recently, The Synanon Distribution Network has begun to arrange for processors to process donated food "at cost," and these costs are added to other handling charges paid by the ultimate recipient organizations. Since the recipient organizations are almost always short of funds, however, the growth potential is limited, even though the food is badly needed.

Gleaning

Finally, we support the provisions of S.1826 that will allow businesses other than corporations to take charitable deductions for donations of product and will allow deductions for food "gleaned" from growers' fields. Much of the food processed in this country is produced by individual proprietors and partnerships, and it is only right that they be able to take the same deductions as corporations. Product that is "gleaned" through the re-harvesting of a field or orchard is put to productive use rather than wasted and should be considered as a charitable contribution in order to encourage growers to allow "gleaning" by charitable groups. By allowing the grower to deduct 50% of the proceeds he would have received if the product were sold, he is given an incentive to donate but does not stand ready to save more on taxes than his cost in growing the product.

Financial Analysis

Using data from the Quarterly Financial Reports published by the Federal Trade Commission, we find that aggregative corporate pre-tax profits for all manufacturing, wholesaling and retailing firms is approximately $200 billion per year. The after-tax income is about 2/3 of pre-tax income indicating an average tax rate of about 33%. Other studies have shown that on the whole, corporate donations to charitable causes approximate 1.5% of pre-tax profit. Thus, we estimate these firms contribute approximately $3 billion annually. Our direct experience indicates that only a small number of firms donate any significant amount of product at all, and that these product donations are only a very small portion of the charitable contribution of the donor firms. We estimate that they amount to less than 10% of all contributions. In our estimation, therefore, the total wholesale value of all product contributions does not exceed $300 million per year.

For every dollar of additional product contributions which might be generated because of the change, the lost tax revenue would be about $.33. However, since most product would be donated at a wholesale fair market value, the ratio of retail value to lost revenue would be about four to one. If the alternative is to provide public assistance money to buy this product, it is obviously much less expensive to provide the incentive to firms to donate it.

A last benefit of private sector donations and distribution is that the distribution itself provides activity and employment -- some paid and much volunteer -- for people who would otherwise be in a passive welfare situation. To the extent that these people are able to participate in performing the work of distribution (sorting, moving, loading, unloading, and "breaking down" product), their sense of being useful and not "on the dole" is enhanced. We know, also, that the owners and employees of firms that donate product feel good. They know that when the firm donates, they have been able to help people in need and sometimes have eliminated the waste and destruction of usable product. Their participation is often direct and personal. In contrast, when assistance comes from the government, taxpayers do no feel the same sense of personal participation and satisfaction.

To the extent that this proposed change in the law can reduce the growth of government assistance and allow individuals and businesses to participate in helping others, our country will be enriched -- spiritually as well as economically. The Synanon Distribution Network, as an organization, stands ready and would be pleased to supply the Committee with any additional information about our experience in acquiring and distributing product that you might wish. We would be happy to do so in writing or through testimony at a hearing. We appreciate having this opportunity to express to you our views.

Sincerely,

Larry Akey

Larry Akey
For The Synanon Distribution Network

Local Address:
1800 K Street, N.W.
Suite 824
Washington, D.C. 20006
(202) 293-3277

California Address:
P.O. Box 112
Badger, California 93603
(209) 337-2881

LHA/jsa